

# CAPCO

## KEY DIFFERENTIATORS FOR A PRIME BROKER TO STAND OUT

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## SPEED READ

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- Prime brokers (PBs) must stay relevant and stand out to keep and gain hedge fund business in today's market
- A prime broker needs to have a platform that supports core business functionalities incl. robust trade capture, exchange connectivity, asset servicing and others
- Hedge funds are increasingly expecting enhanced capabilities (e.g. data, platform) and more flexibility from their PBs (e.g. charging, pricing)

## INTRODUCTION

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Before the financial crash in 2008, it was common for hedge funds to have only one prime broker (PB). Since then, hedge funds have moved to a multi-prime model, to reduce risk and exposure to their PBs while taking advantage of what each PB offers. Staying relevant and standing out is key to keeping and gaining hedge fund business in today's market.

In recent years, this multi-prime model has meant that hedge funds need to compare and contrast the offerings and services each PB provides. While PBs previously offered broadly the same set of services, they now need to differentiate themselves from their competitors, offering more bespoke services that help them stand

out and matching what demanding clients expect from their PBs.

Hedge funds expect more than basic services (trade capture, stock loan, etc.). PB clients look for additional capabilities: access to specific data, a flexible charging facility, an efficient funding model, competitive pricing, access to additional markets/a large inventory, and a robust platform to support their complete trading activity. For PBs to stay competitive, they need to match their clients' current needs while remaining flexible enough to incorporate future needs. It is a combination of a solid platform and specialized new offerings that will differentiate PBs and allow them to increase and earn a larger share of the global hedge fund wallet.

# CORE PRIME BROKER OFFERINGS

Common PB Platform Capabilities (Illustrative)

	Trade Capture	Trade Booking
<b>Market Data</b>	Stock Loan	
	Swap/Synthetics	
	Fixed Income/Repo	
<b>Static Data</b>	Position Keeping	Client Billing
	Asset Servicing	Settlement
<b>Exchange Connectivity</b>	Real-Time Margin	Real-Time Risk
<b>Agent Bank Connectivity</b>	Client Reporting	Reg Reporting

## A prime broker needs to have a platform that supports the following core business functionalities:

### Robust Trade Capture

with full integration to the portfolio management system, ensuring near-zero exception rate on client trade processing



### Exchange Connectivity

correct position data from all execution venues, creating an accurate view of all client trading activities



### Sophisticated Settlement

supporting large clearing activity and the ability to have a real-time view over the full trade lifecycle



### Strong Asset Servicing Function

with efficient corporate actions and income processing capability, even with large trading volumes



### Efficient Reporting Infrastructure

the ability for clients to tailor reports and run ad hoc reporting



### Real-Time Position Keeping

accurate client exposures, especially in volatile markets



### Real-Time Margin/ Risk

increased market and credit risk management capability is needed due to continued high levels of market volatility, as well as being able to capture client strategies



### Client Billing

efficient client billing for all PB revenue streams for transparent client reporting



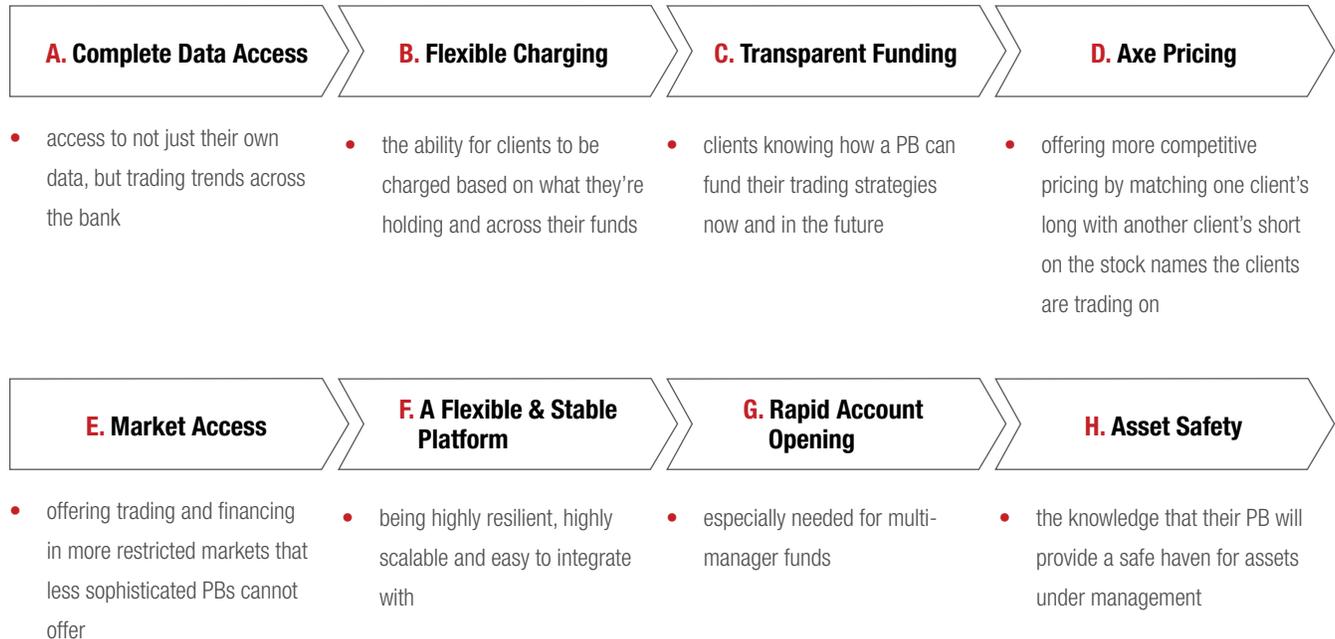
### Collateral / Balance Sheet Optimization

to protect bank's capital position at the same time as ensuring inventory is large/up-to-date



# TRENDING OFFERINGS CLIENTS LOOK FOR FROM THEIR PB

While not exhaustive, hedge funds are increasingly expecting enhanced capabilities and more flexibility from their PBs, namely:



## A. Complete Data Access

Previously, PBs would offer the client access to basic data points, such as position and balance data, but this requires expansion for sophisticated clients. Clients now want access to every part of their data. They expect APIs and connectivity to integrate with a PB's platform on all aspects of their own data, in a real-time manner.

As most funds are multi-prime, clients want the ability to recreate their book across all their PBs. Clients want to see how they are billed and for what, so they can have full transparency on how expensive it is to do business with a PB, resulting in further cost pressure for an inefficient PB.

Often, the largest clients are quant hedge funds, and their data requirements are more complex than the traditional long-short funds. Clients want access to data, such as trading volumes, lot sizes, and liquidity, from the rest of the bank so they can see trading behavior across the wider market. Clients can take this data and input it directly into their trading models, not just to make trading decisions but to assess future trading activity. While some clients might expect access to certain data for free, they may pay for specific data depending on its perceived value. The breadth, quality, and ease of getting data from a PB could be a key differentiator for getting future client business, especially from quant funds.

## **B. Flexible Charging**

Clients expect to see much more flexibility in how they are charged. They expect to be charged less, due to the liquidity of their assets and where they are market neutral in their net position. For example, while PBs would previously levy a fixed basis point charge for lending, they expect to see asset-based charging – fees calculated on their holdings depending on the asset. The more liquid a portfolio, the lower the charges a client is expecting to see, with transparency on how those charges are calculated. A highly scalable and flexible billing engine is needed to support multiple charging strategies.

Fees will be squeezed so it is necessary for a bank to get as much as it can out of its PB. Clients look to leverage their relationship and scale with the firms. For example, if a client has four funds, two of which are short, two of which are long, they are expecting to have no or minimal charges if the shorts net out with corresponding longs, creating a market neutral position across all four funds. These clients look for their PB to have a platform and calculation engine with this capability.

## **C. Transparent Funding**

Funding, and how banks do this, is becoming increasingly important to clients – capital is limited for a hedge fund and PBs have limitations from their organization as to how much of the bank's balance sheet they can offer. Clients expect their PB will have the required liquidity and inventory to support their often-changing trading strategies. Clients are interested in how a PB funds their inventory and that they have the appropriate levels of funding in place, especially in times of volatility. A mature PB should actively demonstrate its funding capability to its clients at any given moment.

## **D. Axe Pricing**

Axe pricing – the scenario where one client's long is matched with another client's short, allows a PB to internalize the swap transaction and offer a reduced fee as the PB is not having to fund the long transaction. Axe pricing is of great interest to clients. It further reduces their trading costs and is beneficial for the PB as they can still get stock loan fees, but with reduced risk and no funding

charges. To offer this service, a PB will require an inventory with a good range of stock names that their client base buys and sells. Publication of axe pricing requires a large client base and matching technology where these trades can be done automatically, with little or no human interaction.

## **E. Market Access**

It is assumed that a PB can offer access to the standard North American, European, and Asian exchanges and venues. Many clients also look for access to more restricted markets, especially in Asia – this could be simply trade execution, but also stock loan/swaps. Accessing the Chinese stock markets via the Qualified Foreign Institutional Investor (QFII) route, for example, is increasingly seen as an attractive offering, especially with many funds having Asian/emerging market strategies. With China in particular, where short selling is not permitted, a good differentiator is the ability to create synthetic shorts via a large Chinese inventory. Offering stock loans and swaps on restricted markets with a good-sized inventory can ensure PBs get access to a much larger hedge fund wallet.

## **F. A Flexible & Stable Platform**

Having a large, monolithic, batch-only platform underpinning a prime brokerage business is becoming a limitation to PBs. Whether vendor platforms, software as a service, or in-house built systems are used, clients expect a real-time solution giving them ad-hoc reporting and enhanced data access. This means that not only does the client want to integrate with a PB's platform to get the required data but also that the data needs to be correct. Fails need to be at a minimum and the positions of the trades executed by a client should be clearly visible whenever they access a PB's platform.

Performing client-specific small enhancements is not scalable if a PB wishes to take advantage of the larger global hedge fund wallet – the IT support costs also become too high. Offerings, such as arranged financing and portfolio margining, are considered basic. A platform should offer multi-asset class servicing with full access and integration to all the bank's products (fixed income, commodities, FCM, etc.).

With volatility, the platforms need to be volume agnostic while offering scalability to compute complex margin calculations and perform efficient collateral optimization. The data that runs the Prime platform (price, static, etc.) should be readily available across all platform components, so there is one version of the truth across the trading stack.

Lastly, release management must be robust and the platform must be highly resilient. Clients expect their PBs to be always up and running – outages due to a bad software release will deter clients, especially high-volume funds.

### **G. Rapid Account Opening**

There is a growing trend toward PBs supporting multi-manager funds, or fund of funds. These funds are particularly demanding in one aspect: the need to rotate and introduce new fund manager accounts on a rapid, almost immediate, basis. How quickly a PB can onboard a new fund manager account is important to these

clients – a prolonged setup would prompt them to take their business elsewhere. The ability to onboard new managers is a key differentiator, therefore, and requires PBs to have a rapid manager account onboarding facility.

### **H. Asset Safety**

The last key differentiator, asset safety, is not something the PB alone can establish. It comes from the wider bank organization. Hedge funds are looking for the highest-possible creditworthiness from their PB – the knowledge that the parent bank will not default and tie up the hedge fund's assets. A low credit default spread is a good indicator of creditworthiness and something clients look for. Assets tied up in collateral for PB margin purposes reduce not only the capital that a hedge fund can deploy in trading strategies but also represent a capital risk if a bank were to default. Taking this capital risk down to the lowest level possible is an attractive proposition for funds that have larger margin requirements.

# CAPCO'S PRIME SERVICES FUNCTION

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Capco is well-positioned to assist PBs with any transformation and enhancement needed to deliver an efficient PB platform, as well as deliver the offerings set out in this paper:

## Prime Expertise

- Our team has worked collectively in prime: product development, front office, operations, and IT
- We're dedicated transformation professionals with a great deal of this experience in prime
- We're experienced in collateral optimization, cross-product margining and clearing, FCM

## Prime Connectivity

- Our team is ex-industry, which means we have deep connectivity into the operations of the leading PBs, as well as the challengers and new entrants
- The prime team has experience working in multiple firms across U.S., Europe, and Asia

## Independent Party/Point of View

- As we serve various departments of multiple financial services clients, we can form a unique, holistic point of view that no one organization could collate
- We're an independent party that can work with both established vendors and FinTech with best-in-class practices in mind

## F2B Assessment Methodology

- We have extensive experience performing F2B assessments of technology platforms and business operations and have a defined methodology that can assess platform capabilities
- The assessments have been focused on cash PB, equity financing, and synthetic prime

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# ABOUT CAPCO

Capco is a global technology and management consultancy dedicated to the financial services industry. Our professionals combine innovative thinking with unrivalled industry knowledge to offer our clients consulting expertise, complex technology and package integration, transformation delivery, and managed services, to move their organizations forward.

Through our collaborative and efficient approach, we help our clients successfully innovate, increase revenue, manage risk and regulatory change, reduce costs, and enhance controls. We specialize primarily in banking, capital markets, wealth and asset management and insurance. We also have an energy consulting practice in the US. We serve our clients from offices in leading financial centers across the Americas, Europe, and Asia Pacific.

To learn more, visit our web site at [www.capco.com](http://www.capco.com), or follow us on Twitter, Facebook, YouTube, LinkedIn and Instagram.

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