acuiti management intelligence

The Rising Risk of FX Prime Brokerage Consolidation

How hedge funds are adapting to an ever more uncertain environment for FX PB

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Introduction

FX prime brokerage has come under pressure as a business line in recent years. Some banks are increasingly adopting a selective stance on who they provide services too, while others have pulled out of offering the service entirely.

That has complicated the task of sell-side relationship management for hedge funds. Increasingly, banks are only prepared to extend an FX prime brokerage line if the client will spread their wallet to other services, such as execution. This has led to a natural consolidation of relationships and an associated increase in concentration risk.

COOs must also pay closer attention to their prime brokers. The challenge facing many hedge funds is that the need for more diversified counterparty risk profiles is increasing, while the number of FX prime brokers available to choose from declines. This is only exacerbated by requests from the sell-side to consolidate services with them or levying increases in requirements for minimum levels of activity.

This is creating significant risk for hedge funds. The onboarding time at a new prime broker is often longer than the notice given for firms when they are offboarded — leaving funds exposed if a core provider ends the relationship.

At the same time, hedge funds are diversifying their exposures, looking to trade in more emerging and frontier markets. While the opportunities in these markets can be significant, the challenges to gain exposures are also high, especially if current prime brokers do not offer a full suite of currencies.

To understand how changing approaches to FX prime brokerage across the sell-side is impacting hedge funds, Acuiti was commissioned by Standard Chartered to survey or interview 57 hedge funds about how they view the FX prime brokerage market, their attitudes to counterparty and offboarding risk and what matters most to them in a prime brokerage relationship.

The key findings are:

- Hedge funds are reducing the number of FX PB relationships as providers retreat from the market or impose minimum revenue requirements on clients
- Concern is high across the market about dependency on key providers with almost 70% of hedge funds in this study either very or quite concerned about the impact that the withdrawal from market of one or more of their FX PB providers would have on their business
- Concern is highest among firms that had gone through the experience of being offboarded by an FX PB provider
- Firms that had lost access to a prime broker reported reduced access to liquidity, costs of reallocating and integrating with a new provider and increased operational risk
- Over a third of survey respondents said that they did not have an executable backup plan if they were offboarded by their core FX PB provider
- Hedge funds are looking to grow their FX PB relationships despite the challenges in order to access unique opportunities in the international market

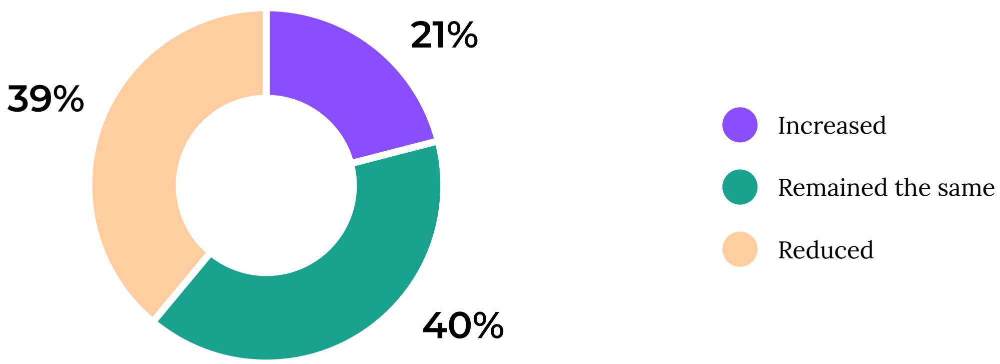
The rising risk of consolidation

Over the past decade, a series of high-profile losses at major prime brokerages has focused attention on the business line and the risks entailed in offering it to clients. This was compounded in 2021 by the collapse of Archegos Capital Management, which resulted in billions of dollars of losses across the sell-side. While the Archegos losses derived from equity products, the incident resulted in a widespread review among the sell-side of the risk that is associated with servicing hedge funds.

These developments coincided with a general push from banks to favour larger clients that can deliver revenues across a wide range of services. That trend has put some business lines that were once seen as sustainable as standalone offerings, including FX prime brokerage, under greater scrutiny.

For now, however, this study found that most hedge funds have been able to maintain a relatively well-diversified counterparty profile for FX prime brokerage. The vast majority of hedge funds that took part in our survey reported had multiple FX prime brokerage relationships. Those that had one FX PB tended to be hedge funds with small AUM or report low FX volumes as the reason for a single relationship. However, 39% of respondents reported a decline over the last three years in the number of prime brokerage relationships that they maintain.

How has the number of PB relationships changed in the past three years?



Over a third of firms that had reduced the number of PB relationships had done so based on an internal decision to consolidate PB relationships, 24% had cut the number of PBs they work with because they had been offboarded by their existing provider. In addition, a third of respondents that had reduced prime broker relationships reported that one or more of their providers had withdrawn from the market.

WHY HAVE HEDGE FUNDS REDUCED PRIME BROKER RELATIONSHIPS?

38%	33%	24%
Internal decision to consolidate relationships	Existing provider withdrew from the market	Offboarded by one or more providers

Offboarding was particularly an issue for funds with lower AUMs – just 18% of firms with an AUM of more than $1bn had been offboarded compared with around a third of those with an AUM of below $1bn. This highlights the need for a strategic relationship with a prime broker that doesn't require multi-product engagement.

Reductions in the number of PB relationships is not necessarily a universal negative for funds. Three quarters of respondents that had reduced the number of PB relationships reported one or more positive impacts from doing so with reduced costs (67%), increased capital efficiency (42%) and simplified counterparty management (33%) the key benefits. However, for many firms that were either offboarded or forced into a reduction through the withdrawal of one of their PBs from the market, the negatives outweighed any benefits.

Offboarding is an arduous and disruptive process. Hedge funds that had been offboarded in the past said that they had principally been impacted by reduced access to liquidity, with the costs of finding and onboarding with a new prime broker also cited as a significant drag.

How did the withdrawal or offboarding of your FX PB impact your business?

1. Reduced access to liquidity
2. Costs of reallocating and integrating with a new PB
3. Increase operational/settlement risk
4. Requirement to change technology infrastructure

In the current consolidatory environment for PBs, these challenges are amplified. As a result, respondents to the survey expected that the biggest challenge in onboarding with a new provider to be finding the right provider and getting accepted by them.

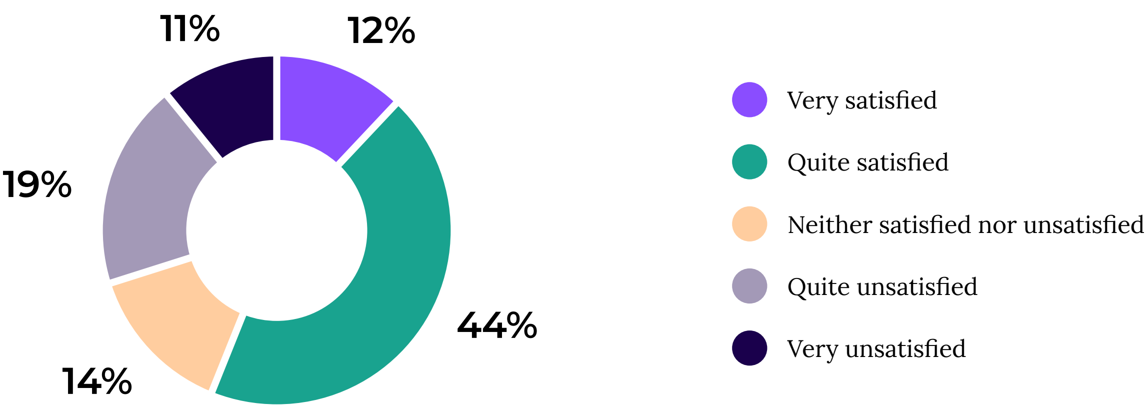
What is, or do you think would be, the biggest challenge when onboarding a new FX PB relationship?

1. Finding the right provider
2. Getting accepted by our preferred provider
3. Internal opposition to change
4. Lack of operational time/resource
5. Lack of legal time/resources

The need for more PBs

What is emerging is a two-tier market — where the largest hedge funds enjoy the full suite of prime brokerage services while smaller funds risk facing incomplete offerings with a limited number of providers. This divergence was perceptible in hedge funds' satisfaction levels with the number of FX prime brokers available to them. Roughly the same proportion of respondents were very satisfied as very unsatisfied but smaller firms were significantly more likely to be unhappy with their FX PB options – 43% of firms with an AUM of less than $1bn were either quite (30%) or very (13%) unsatisfied, compared with 12% and 8% respectively among firms with an AUM of over $5bn. Smaller hedge funds in particular are looking for FX prime brokers that don't require multiple products to be onboarded in order to reduce the risk of losing access to this vital service.

How satisfied are you with the number of FX PB providers available to your business?



In addition to some prime brokerages exiting the market altogether, many of those that remain are taking an increasingly selective approach to their client lists. The return that senior executives demand from prime brokerage relationships has increased in recent years – a trend that biases towards winning business from larger funds.

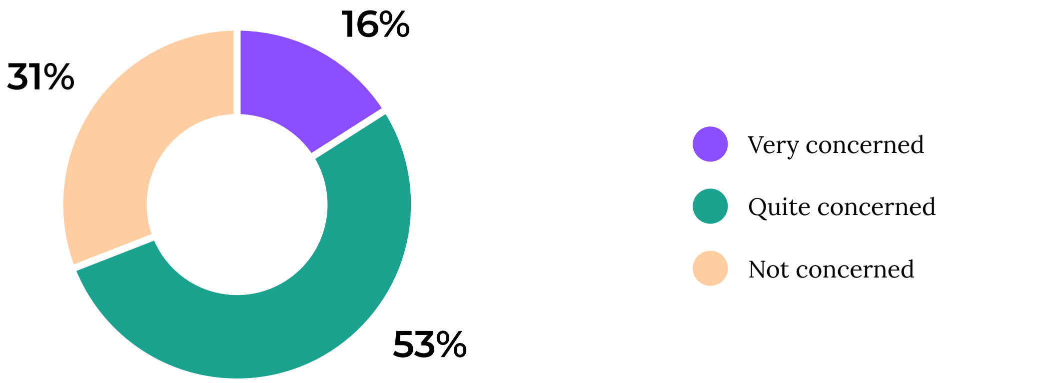
This has accompanied a focus at some banks on a siloed approach, which has in turn put more scrutiny on the costs and risks of FX prime brokerage as a standalone business. While the revenues this business line brings in can be healthy, they are often lower than other desks and the associated risks can be higher.

The lack of available options for FX Prime Brokers, in particular for hedge funds with less than $1bn in AUM, is creating significant operational and concentration risk in terms of hedge funds' exposures to core providers.

Of the respondents to the survey, 69% said that they were either very or quite concerned over the impact that the withdrawal from the market of one or more of their FX prime brokers would have on their business.

Most notably, the strongest level of concern was among firms that had gone through the experience of being offboarded, either as a result of a review by a PB or because their PB had withdrawn from the market.

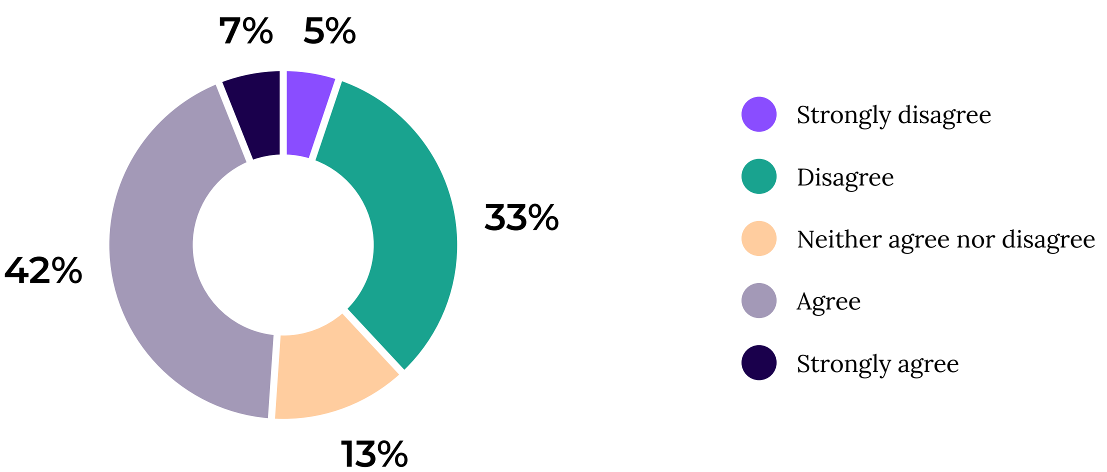
How concerned are you about the impact that the withdrawal from the market of one or more of your FX PB providers would have on your business?



Offboarding clients is not a decision that prime brokers take lightly. The decision to do so is often taken due to serious concerns, such as a funds proximity to a sanctioned regime, or excessive risk in a client's trading book. However, these actions are increasingly taken due to commercial considerations. Despite the headaches that it causes for both parties, offboarding is becoming more frequent.

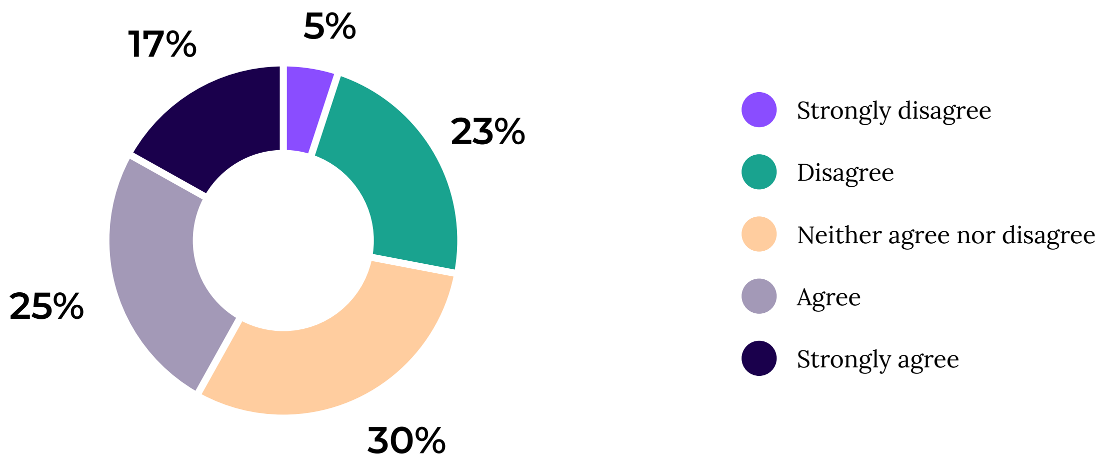
The risk that this poses to hedge funds is clear: over a third of survey respondents said that they did not have an executable backup plan if they were offboarded by their core FX PB provider. This highlights the risk building up in the market that funds could be left with reduced access to liquidity and facing higher costs to execute their strategies. This risk can be mitigated by having a back-up PB.

We have an executable backup plan if we were off boarded by our core FX PB provider:



A further challenge is the breadth of services that many PBs require when onboarding clients. Almost half of respondents said that they would find it difficult to onboard with a new PB just for FX.

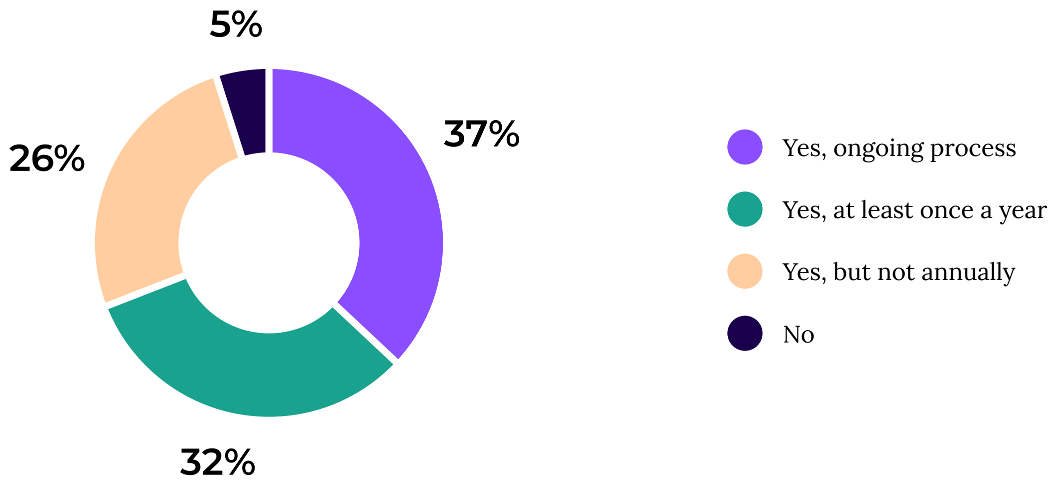
We would find it difficult to onboard with a new Prime Broker just for FX:



While prime brokers are asking more questions of their hedge fund clients, the scrutiny goes both ways. The Archegos incident raised questions about some prime brokers' due diligence and risk management. Since then, the understanding of the risk of prime brokers exiting the market has increased.

Managing counterparty risk therefore is as important for hedge funds as it is for their prime brokers. Most survey respondents reported conducting reviews or due diligence of prime brokers at least once a year, with the majority of that number doing so on an ongoing basis.

Do you routinely review or conduct due diligence on your prime brokers?

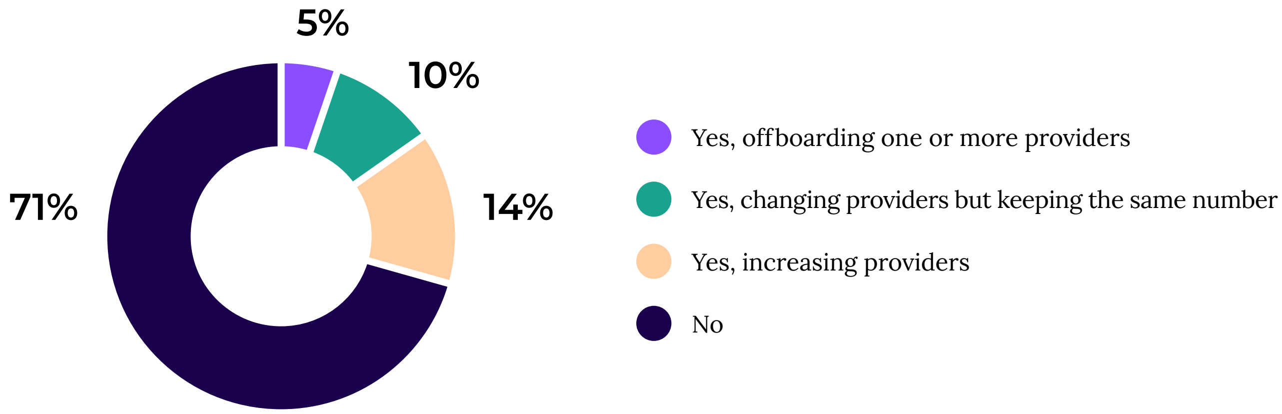


When conducting their prime brokerage reviews, hedge funds focused on access to liquidity and cost efficiency. Other considerations such as compliance, products and currencies offered were also ranked highly as well. This variety of concerns show that clients still desire a high touch and broad reaching service from their prime brokers.

Future proofing PB relationships

The past five years has been defined by reductions in the number of prime brokerage relationships, in part as a result of firms withdrawing from the market or offboarding certain clients. This trend, however, appears to have reached a natural nadir, with 71% of respondents currently looking to maintain their existing level of providers and 24% considering changing or increasing providers.

Are you currently considering changing your FX PB providers?



The main reason that survey respondents gave for changing their prime brokers was seeking to reduce costs, with the strengths of new providers' offerings also cited, as well as capital efficiency.

Similarly, the reasons for firms looking to increase providers was tied to unique offerings or opportunities or to achieve geographical diversification.

Why are you changing providers?

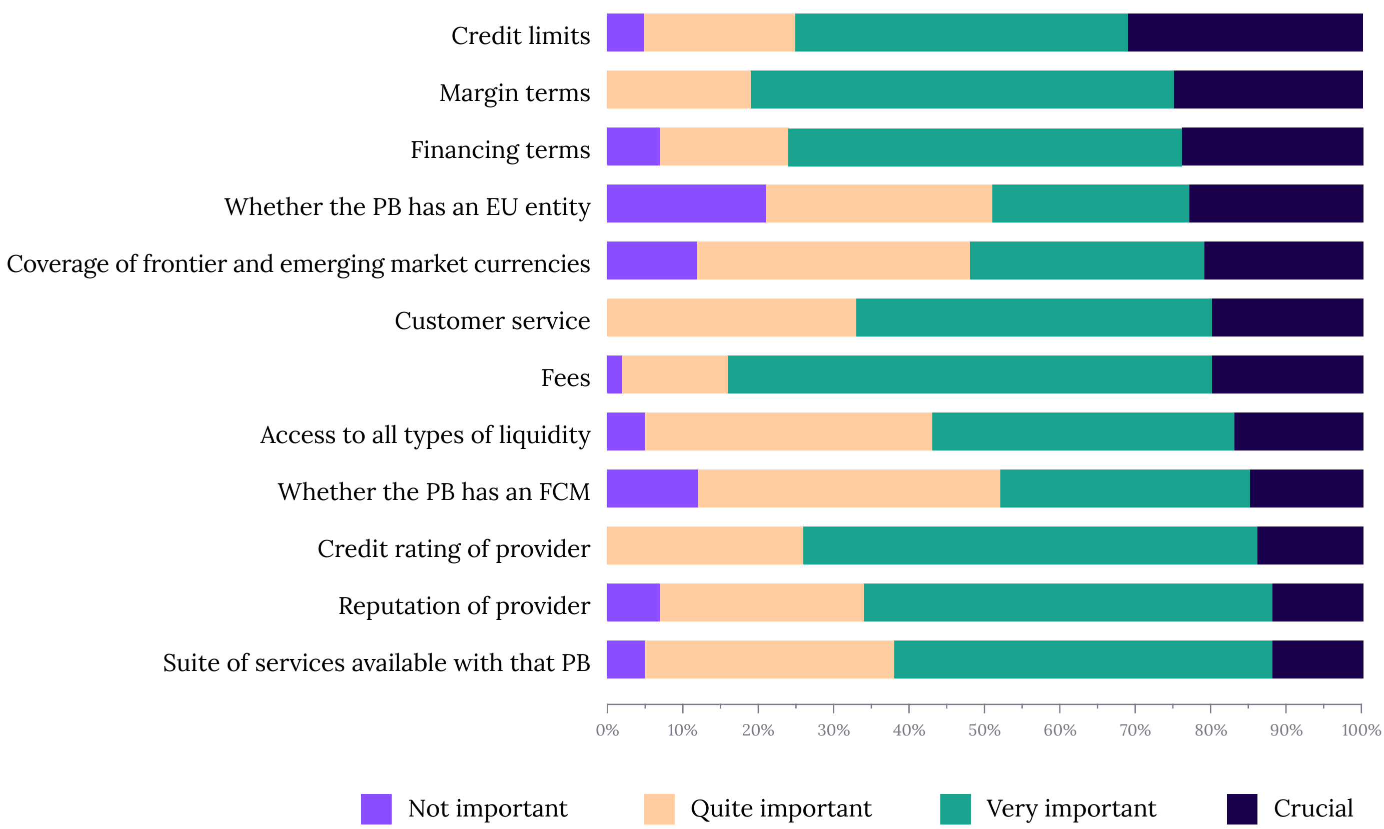
1. Seeking to reduce costs
2. Strengths/unique offering of new provider
3. Seeking to increase capital efficiency

Why are you increasing providers?

1. Strengths/unique offering of new provider
2. To capture new or unique trading opportunities
3. Geographical diversification

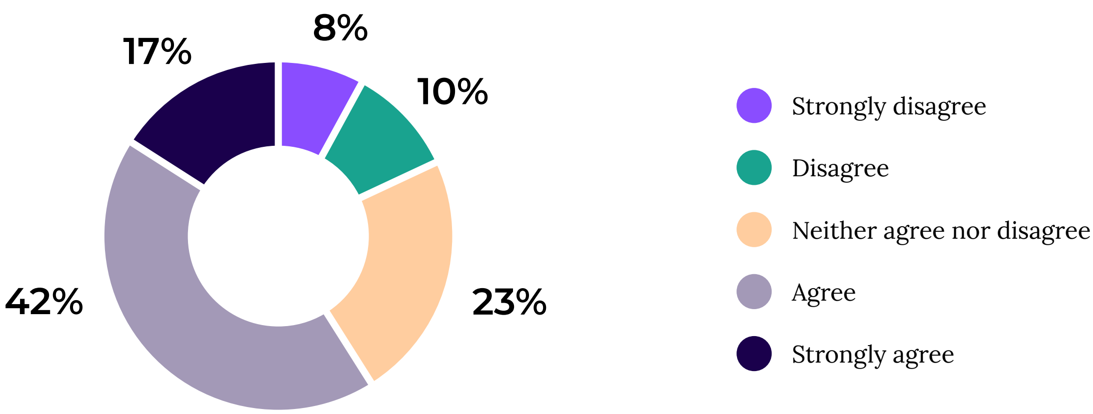
When it came to the factors that funds consider when evaluating their PBs, credit limits, margin and financing terms were the most important factors — followed by the requirement to have an EU entity, which was particularly important to UK and EU firms, unsurprisingly. In addition, coverage of frontier and emerging markets, customer service and fees were also seen as important factors.

When evaluating an FX PB, how important are the following factors?



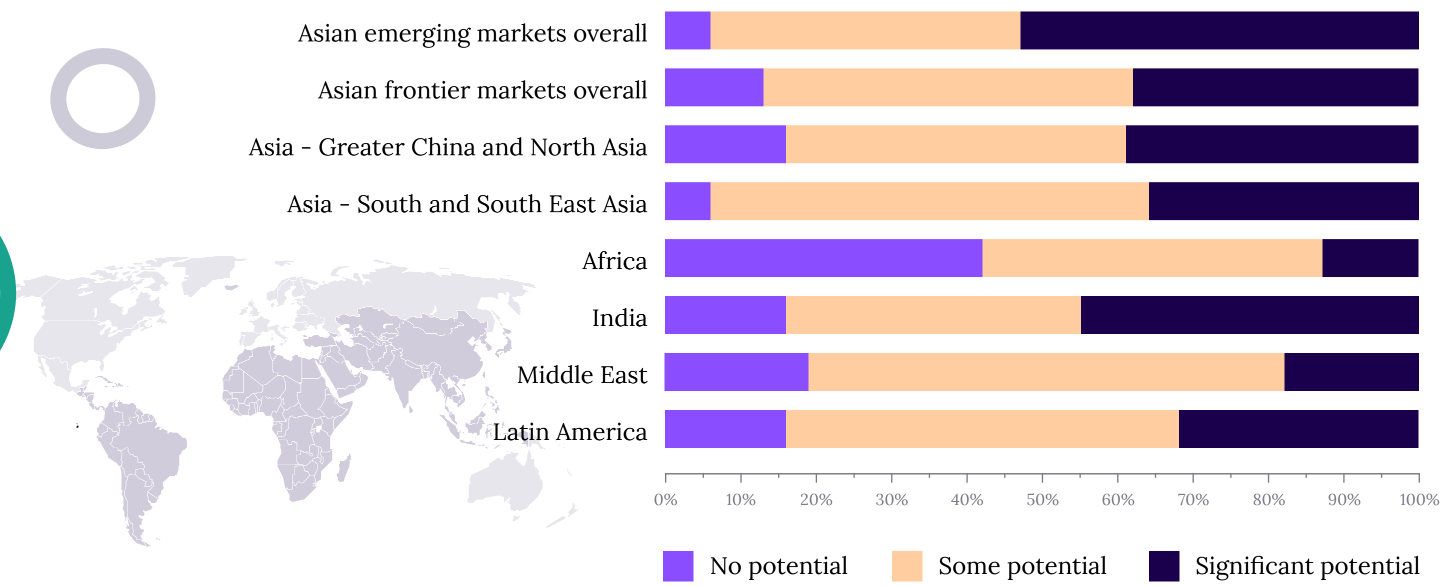
The growing desire to trade emerging and frontier market exposures is often limited by the breadth of currencies offered by FX prime brokers, however. 61% of respondents said that the ability to add any global currency to their tradable universe would enhance their trading strategies, representing the desire to expand horizons, as opportunities in established markets are subject to increased competition. In a related finding, 38% of respondents said that they had missed opportunities as a result of not being able to rapidly and cost effectively trade a new currency or market.

The ability to add any global currency to our tradable universe would enhance our trading strategies:



The bulk of this demand for new geographies is set to focus on Asian emerging markets overall in the coming five years, but there was also noticeable bullishness on frontier markets in the region. India is also a popular region for growth.

How much potential do you see in the following regions in terms of optimising your trading strategies over the next five years:

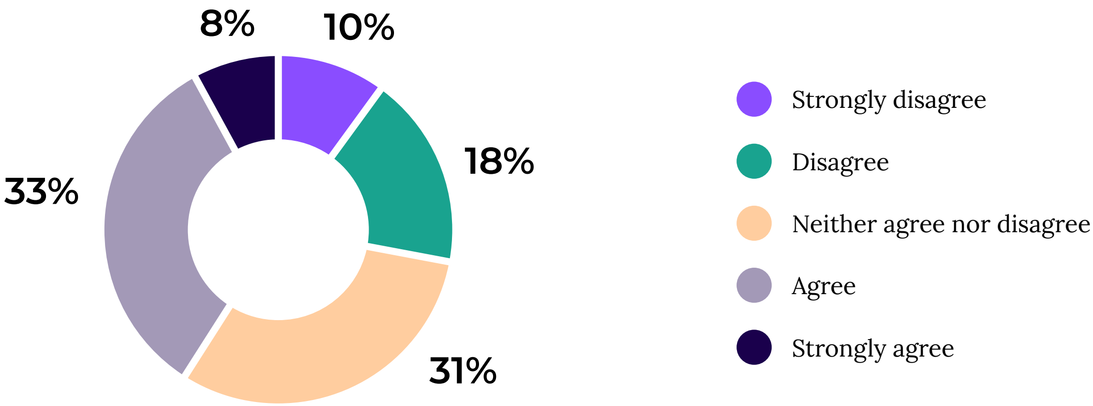


Establishing the right connectivity, relationships and risk management infrastructure for the currencies of these regions, especially in frontier markets, is not a cost that many prime brokers are willing or able to maintain.

This situation is a bottleneck for hedge funds looking to trade these markets, as the opportunities often rely on the ability to execute rapidly, while onboarding a new currency at a firm that does not specialise in that market can take time.

A further consideration for hedge funds when considering their FX PB relationships is diversification, both geographical and from a concentration risk exposure. In this regard, 28% of respondents said that they were not well diversified in their exposures.

We are well-diversified with our existing service providers from a G-Sib / Geopolitical perspective:



Nuances in Asia

Hedge funds in Asia have a different profile in terms of the findings of the survey to firms in other regions.

While the AUM spread of firms in Asia was similar to the overall survey demographic, they were half as likely to have reduced the number of PB relationships over the past three years and typically had fewer relationships for their size.

Hedge funds in Asia were also more satisfied with the number of FX PB providers available to them with just 14% quite unsatisfied, none very unsatisfied and 36% quite and 21% very satisfied.

Despite this, however, levels of concern over the withdrawal of a core provider were only marginally lower than the total average across all survey respondents.

Firms in Asia were much more fee sensitive than in other regions with all respondents saying that fees were either very or quite important when considering an FX PB providers.

Unsurprisingly, there were less concerned over whether the provider has an EU entity although there was a split with 20% citing this as a crucial factor and 40% saying that it was not important.

Funds in Asia also attached greater importance to the reputation of their providers than firms in other regions.

Hedge funds in Asia were consistent with other regions in terms of the extent of a back up plan if their core provider exited the market but were significantly more likely to say that they were not diversified across their providers.

Conclusion

Hedge funds, particularly new launches and those with lower AUM than the dominant industry players, face a challenging landscape when managing FX Prime Broker relationships. Not only is the number of providers to the market falling, but those that remain are becoming increasingly selective about who they onboard.

In addition, Prime Brokers are increasingly offboarding existing clients for commercial reasons. This is a long and arduous process, during which funds suffer significant operational disruption and risk losing access to liquidity.

While prime brokers that have given an offboarding notice will try and allow the process to last enough time for their clients to find a new provider, this is not always guaranteed.

Prime brokerage desks often receive pressure from their risk management colleagues to get clients off their books as soon as possible, thus increasing the risk of a mismatch between offboarding and setting up with a new provider.

At the same time, the need of hedge funds to have greater access to emerging and frontier markets is growing. Funds must therefore find Prime Brokers both willing to onboard them and to offer the diversity they need. In a declining market, these are fewer and farther between.

Finally, increasing numbers of firms are seeking to expand the number of prime brokerage relationships that they have, in an effort to mitigate the risk of one of their existing counterparties pulling back from the market to capture unique trading opportunities.

This is creating an opportunity for the sell-side to fill the gaps either through expanding their client base and offering geographical diversification or through the expansion of their FX PB as a whole.

For smaller firms, the pressure to maximise revenues across their services is lower than at the tier 1 banks. Those that seek to accommodate the demand in the market will likely reap the rewards.

Methodology

This whitepaper is based on a survey of 57 hedge funds. Respondents were from North America (19%), the EU (24%), the UK (29%), Asia (22%) and ROW (6%). The AUM of respondents was $0-100m (11%), $101-500m (16%), $501m-1bn (14%), $1-5bn (23%), $5bn+ (37%). In addition, the survey was supplemented by interviews with hedge fund executives and sell-side providers.

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