PRIME BROKERAGE & CORONAVIRUS: FIVE INDUSTRY OBSERVATIONS

In this article Anthony Bennett, Capco UK's Prime Brokerage Practice Lead shares some consolidated industry insights in view of the ongoing coronavirus pandemic, based on recent conversations with leading primes.

SPEED READ:

1 PRIMES HAVE LEARNED LESSONS WELL… TO DATE.

They have weathered the initial storm of volatility, de-risking and volumes, achieving this owing to previous investment in platform maintenance, automation of tasks and close management of client portfolios.

2 IT'S THE REBIRTH OF EQUITY LONG-SHORT STRATEGIES WITH SIGNS OF 'PEAK QUANT'.

Within the strategies catered for by primes, there are some potential changes coming that will impact a prime's business mix, notably a move from Equities to Credit and Fixed Income.

3 WHEN IT COMES TO REGULATION, IT'S BUSINESS AS USUAL.

- Whilst there are some delays mandated by regulators, primes still need to focus on the target operating model impacts of SFTR and CSDR for example, which have an impact on a prime brokerage's transactional engine.
- Prime and country heads have a clear focus on the UK SM&CR responsibilities around operational resilience.
- Primes that have ring-fenced their change teams have navigated the shift to remote working patterns and managing the demands most efficiently.

4 DIVERSIFICATION REIGNS.

The most diverse businesses have proven to be the stronger primes.

5 WE'RE SEEING AN ACCELERATION OF THE FUTURE OF PRIME.

- The COVID-19 period has redoubled the focus on cost reduction - but siloed efforts to this end can only go so far. Hence new prime target operating models are being deployed that merge their platforms with those of other global markets businesses; plus, the march towards greater agility and the use of cloud native solutions are all being moved up the order.
- Using consulting firms to provide domain expertise, increase bandwidth and accelerate efficiency is reaping benefits.

As clients deleverage and the industry adjusts accordingly, the publication of a slew of poor hedge fund performance results[1] and inevitable waves of asset rotation or redemptions have seen familiar themes re-emerge.

This serves as a timely reminder of the rigors around best practice platform management and building scalable, diversified businesses. The industry is to proceed with caution at a time of ongoing squeezed margins, cost management and transformation pressures.

1. Primes have learned lessons well… to date.

From mid-February to the end of March, trading volumes were significantly raised, with an average of four times daily volumes going across the primes' books at the peak. This was a period when prime brokerage firms needed to be able to focus on managing their risk exposures rather than dealing with system outages.

The primes that had previously fought for internal funding during lean times and ploughed those resources into enhancing their platform capacity and delivering STP improvements have since reaped the benefit.

At the time of writing, primes have passed an initial test of resilience. Lessons learned from prior unexpected peaks (such as Trump's election and the Brexit referendum) have been taken onboard, but the message remains clear: invest in the disciplines of testing and expand your platform capacity.

Those primes who took a rigorous and disciplined approach to maintaining their platforms have seen their investments repaid in the shape of enhancements on two fronts:

a. Their systems – and the ability to handle burst volumes, higher STP rates, overall capacity, failover site testing, key person risk removal, the automation of tasks and provision of outage alerts.

b. Risk management – the tightening of processes around client monitoring. Managing the tail risk has been a major focus for primes, and this is an area where it really paid off. Save for one known volatility arb fund blip, industry prime risk heads have 'earned their corn' in terms of longstanding best practice.

There has clearly also been an orderly management of ongoing deleveraging.

2. It's the rebirth of equity long short strategies with signs of 'peak Quant'.

The largest, most diverse primes are faring best. Regarding their client base, there is a nascent view that the period may have signaled peak quant for equity and futures strategies, and the rebirth of equity long/short. Many primes questioned how much new investment will go into quant hedge funds, when so many fund managers have been chasing the same pockets of opportunity to so little effect in terms of performance.

A number of challenger primes have grown their business in recent years through a focus on servicing quants. The provision of such services to that client base relies on three things: a strong balance sheet, robust technology/pipes, and access. Will these firms now look to invest in their classic prime brokerage framework instead? That is yet to become clear, and typically remains something the established prime market leaders have been consistently good at (and therefore difficult for challengers to gain market share). How primes pivot their businesses to support offsets for potential Credit and Fixed Income activity will require a mature platform, plus a focus on execution, liquidity, custody and risk.

To become a dominant player in the equity long/short supporting prime space requires time – to both develop the required level of franchise maturity, as well as research, inventory and access-driven products.

Primes that have associated clearing businesses of significant scale have enjoyed record ticket fees, driven by market maker activity and the higher volumes.

A few top tier primes are on record as noting that that this should not be mistaken for pursuing diversified business at any cost. Sticking to the models you can support is a sound strategy.

One lesson of the COVID-19 crisis is where primes have been attempting to serve bespoke client needs. This has highlighted an over-reliance on manual workarounds to service those bespoke requirements, which in turn, have revealed a lack of scalability.

1. https://hfm.global/insight/hedge-funds-in-q1-2020/

3. When it comes to regulation, it's business as usual.

2020

JULY
EU Tax MDR Reporting starts
SFTR - Final wave of reporting requirements
SMRC
MiFID/MiFIR consultation closes

Q1
JAN – EU FTT- Date of compliance
ESEF – New reporting format launch
MAR – FCR Directory for SMCR Firms

DECEMBER
MiFID/MiFIR OTF, SME growth markets and algo trading
EMIR 2.2. Draft RTS

JANUARY
Conclusion of EU Benchmarks Regulation transition plan
EMIR 2.2 entered into force

Q1
Capital Markets Union Standards anticipated deadline
PRIIPs Reg

MAY
GDPR

JUNE
EMIR REFIT mandatory reporting

SEPT - NOV
UMR Bilateral Margining Phase 5

SEPT – SRD II

OCT – FCA/PRA consultation closes
SFTR Reporting

NOV – Target 2 Securities

Across 2021-2022
Anticipated implementation dates for Basel III enhancements (CVA, SMA, SACCR, SACR, Leverage Ratio)

2021

JANUARY
IFRS 17 - Date of compliance
SFTR Reporting

APRIL
UCIT and **AIFMD** amendments on safekeeping

JUNE
IFD/IFR goes live

SEPT
UMR Phase V goes live

Q4
IBOR
Completion of SOFR adoption

FEB
SRD II, CSDR Settlement Discipline

Q3
FRTB reporting reg conversion to capital requirement starts

DEC
BRRDII/CRD V
SRMR II

2022

JANUARY
FRTB – Date of compliance
MiFID/MiFIR interoperability access exception benchmark

Q2
BASEL IV, CRDV, CRRII Rules adoption

JUNE
CRR II

SEPT
UMR Phase VI goes live

Notes:

- MiFID, EMIR and AIFMD are under ongoing review by ESMA, which means changes to the already implemented rules may need revising.
- In the UK, primes are regulated by the FCA and must therefore comply with the FCA Client Assets Sourcebook (CASS), CASS 3 (Collateral Rules), CASS 6 (Custody Rules), CASS 7 (Client Money) and CASS 9 (Prime brokerage). The FCA's operational resilience and SMCR will also apply to primes. LIBOR work must be added, which effects the wider landscape.
- Read our Regulatory Horizon newsletter to stay up to date with the ever-evolving regulatory landscape.

As regulators globally react to the ongoing COVID-19 crisis by publishing guidance and extending implementation timeframes and compliance milestones, it is worth acknowledging that these actions do not really provide much breathing space, if any. Conversely, it should be noted that regulations put in place post-2008 have to date had a positive impact on the mitigating the impact of this crisis, notably in terms of client asset protection.

Regulatory project teams were already challenging the viability of timeframes for production testing and implementation of target operating model impact recommendations. The complex regulations hitting prime brokerage and equity finance's end-to-end processes have uncovered some unique challenges, especially in relation to how a prime business internalizes and optimizes itself across client assets, margin financing and securities lending for front, middle and back office. Hence for project teams, regardless of adjusting to working remotely, existing timelines are largely unchanged.

Ensuring your work from home teams are productive and focused can be challenging, particularly given that access to decision makers within the business has been reduced due to 'run-the-bank' crisis management. However, to stay focused on both priorities, firms should ensure that there is a clear delineation between the 'change the bank' and 'run the bank' teams. Those primes utilizing dedicated change teams and external forces are finding their regulatory change programs to be moving on track.

New regulatory projects are understandably on hold, pending clarity around the length of the lockdown and further communications from authorities. Primes are not awash with discretionary spend, but this will be a period during which regulators will scrutinize operations and compliance in some detail, hence governance and controls will need to be documented and be shown to have worked. One area of focus will no doubt be any spikes in lock-ups of client money, and indebtedness calculations as positions were taken off. One top tier prime commented that they have ensured these swings were well-observed and annotated in their governance decks to highlight; and they also evidenced that their controls had been effective.

Looking beyond established regulations, which must remain under constant review and assessment –the Client Assets Scorecard (CASS), for example - the timeline for proposed regulations is currently in question. The postponement of UMR, Uncleared Margin Rules' next phase, the three-month delay to Securities Financing Transactions Reporting (SFTR), a tightening of timeframes around trade reporting, question marks around the implementation of the Central Securities Depositories Regulation (CDSR). Despite these adjustments to the regulatory calendar, such in-flight projects remain key to unlocking the value in data provision, intelligent automation and optimizing roles and responsibilities across teams (and bundling such initiatives into existing regulatory programs would offer additional value in the current environment).

As one prime told me, "Day 1 regulatory adherence is half the battle. It is Day 2 exceptions management and target operating model optimization that are crucial to avoiding an ongoing drag on your business. It is in that Day 2 optimization that efficiencies are gained."

Prudent banks have already begun to reassess and accelerate planning around future operational resilience, and the various regulations pending in the UK make this a must have. In summary, the work still needs to be done, and if you can leverage a dedicated change function or consulting firm, then push on and avoid diverting funds from already committed regulatory spend. Use this time wisely as it will prove an operational cost advantage in the long run.

4. Diversification reigns.

On all sides of the sales conversation, preparations are underway for discussions around repricing conversations to begin, prompted by moves into new strategies, adjustments to book composition and shifts in funding demands. Again, a diversified prime will have more scope for flexibility here. Everyone is open for business - but only at the right price, especially when stable sources of efficient funding have been hard to come by. For example, a perceived move towards credit strategies is good news for execution desks, but less so for financing businesses.

Balance sheets may be constrained for the medium term, due to parent banking groups' exposure and political pressure to extend lending to corporates. Margins will be squeezed and leverage is already off. Hurdle rates and minimum account pricing will be subject to further reviewed.

To retain a commercial edge, prime business heads are laser-focused on controllable costs. To this end, multi-functional, Agile teams are already being put in place, with a view to merging product development, front office technology, coverage and relationship management-functions and teams to generate new efficiencies and enhance client service.

The question of where the prime business should sit within an organization may again rear its head. The merging of the prime sales and coverage teams with electronic execution businesses and wider securities franchises may now fully occur. Potential efficiencies in the case of those primes allied to investor services platforms will also be examined.

We have already seen an ebb and flow of prime client service/relationship management teams moving between operations and front office. That question goes away with data-driven technology and agile teams, and even cross product. Hence, the overall target operating model for coverage of PB clients may be reviewed.

5. An acceleration of the future of prime.

Prime brokerage business leaders have been vocal as to their need for real-time dashboards: whether operational, exposure-led or driven by client activity/CRM or broker scorecarding, very few have them. Uptake will now accelerate, the rush for information having reminded prime COOs of just how many manual MI processes remain.

Data extraction solutions are efficient and allow business insights to rise above the day-to-day background static. Near real-time data-driven automation was already charting regulatory adherence into more efficient waters; now there is a real value-add business-led case for delivering it.

This emphasizes the need to understand an organization's 'Digital Twin'[2], which sets out its operating models in a manner which is navigable and can be queried. This allows a clearer understanding of the 'what-if' ramifications of different scenarios. We foresee prime organizations needing to stress test their operations much as they currently stress test their client portfolio risks.

Having spoken to various prime COOs, there is a consensus that the pandemic has precipitated an increased demand for additional real-time data, which is now viewed as a priority.

The path to digital enablement was already underway in this space, as evidenced by for the take-up of cloud native booking systems, the use of APIs and doubling down on decommissioning legacy mainframes that underpin already expensive-to-run architectures.

Post-trade reliance on offshore serviced exceptions management is under close watch, as countries with less proven working from home environments potentially come under strain in the coming months. Some smaller primes have noted a slowdown in post-trade operations, as they had offshored some manual processes as a cost play rather than make an investment in automation. Targeted investment in the prime post-trade value chain clearly remains a consideration.

Conclusion

Prior to COVID-19, the industry was already facing dual challenges of rising costs and compromised profitability. However, primes have to a large extent passed the first tests posed by the pandemic relating to volumes and credit risks. Future disruption will need to be managed in tandem with catering to the shifting client activity. All this against the backdrop of an uncertain – yet still pressing - regulatory timetable. These are front and center for primes from a scenario-planning perspective right now. Preparedness, bandwidth and flexibility will be key to adjusting to this new environment.

We are helping prime brokers to reduce costs through implementing API and data-driven, cloud-based platforms, whilst also supporting the implementation of regulations and managing technological change. We believe the future state of prime brokerage is a Prime-as-a-Service model, which will allow primes to provide data and services that more efficiently support their client's strategies. Find out more by contacting the author, Anthony Bennett.

2. https://capco.com/Intelligence/Capco-Intelligence/Data-Differentiators-For-2020-A-Covid-19-Update

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