Collapse of Lehman leaves prime broker model in question
James Mackintosh

For the past year some of the smartest people in the hedge fund industry have been worrying about the safety of their prime brokers, the lucrative arms of investment banks which service hedge funds.

This month the dangers shot into the open, as the collapse of Lehman Brothers led to concerns about the survival of Morgan Stanley and Goldman Sachs, the investment banks which run the world's two biggest prime brokers. Among hedge funds this caused widespread panic. Funds that used Lehman - including GLG Partners, Amber Capital and Ramius - have found they cannot access a total of $40bn of assets held at the European arm of the bank.

Those that did not use Lehman raced to shift money out of Morgan and Goldman into the prime brokerages of commercial banks regarded as safer, including JPMorgan Chase, Credit Suisse, Citigroup, Deutsche Bank, Barclays Capital and UBS. A handful of jittery hedge funds cut their borrowing and moved assets to custodians such as Bank of New York Mellon and State Street, who guard trillions of dollars for mutual fund managers and institutions.

In the process hedge funds caused wild swings in shares such as Volkswagen, buying back stocks they had been betting against and trying to hedge positions stuck at Lehman. "Every minute that these assets are frozen and we are unable to trade on them is a minute of significant potential harm to our investors," Amber Capital said.

Many hedge funds are still buried in the rabble of Lehman, but others are pondering their future banking relationships. Their concerns go to the heart of the prime brokerage business model, which is built on a practice known as rehypothecation. A proportion of assets used to back loans can usually be "rehypothecated" into the prime broker's name, so the broker can use them to raise cash.

This cash is then used to fund lending to funds for leveraged purchases, and to support the borrowing of stock the prime broker can lend to funds wanting to go short.

The dangers for hedge funds of having their assets rehypothecated became painfully clear last week: $22bn of the $40bn held by Lehman's European prime brokerage had been rehypothecated.

Hedge funds trying to reclaim the rehypothecated assets have found themselves in the queue of general creditors, likely to get back only a proportion of their money.

Even those hedge funds which had insisted they did not want their assets rehypothecated such as Amber and a small RAB Capital fund - face a long and potentially painful wait to get back securities held in segregated client accounts. PwC, administrators of Lehman's London business, have told hedge funds it is likely to take months to calculate how much is due to whom, and to offset this against debts.

But it is rehypothecation which poses the biggest threat to hedge funds, and could lead to the biggest changes in the prime brokerage industry.

The main prime brokers were almost completely self-funding, according to current and former executives, needing very little access to the balance sheet of their parent bank, thanks to hedge fund cash kept on deposit and the rehypothecation of assets.

Most of the cash has already gone, hedge fund managers say, shifted away from prime brokerages to banks regarded as safer.

Take away rehypothecation, and banks will have to borrow at far more expensive rates in order to lend to hedge funds, pushing down their profitability and pushing up the cost of borrowing.

"Corrective action needed to take place because a rush of prime brokers into the market had caused aggressive margin pricing," said Nick Roe, head of prime finance at Citigroup. "Some hedge funds were getting extraordinarily cheap money.

"If hedge funds now say you cannot rehypothecate, the cost of finance may be more expensive than hedge funds are willing to pay."

Exactly how much more is hard to calculate, but brokers estimate the cost of internal financing across City and Wall Street banks is now 1.5-3 percentage points over Libor, against about 0.6 points for rehypothecated assets.

Some bankers argue that the prohibitive cost will make hedge funds stick with prime brokers and rehypothecation. Others, though, argue that big changes are on the way.

"What we have now is a great opportunity to reduce the structural and systemic risks from counterparties in hedge fund investing," said Rick Sopher, who oversees investments in hedge funds at LCF Rothschild Group.

For some of the biggest institutional investors in hedge funds, the small risk of a bank collapse taking out a series of funds is seen as much more dangerous than accepting lower returns.

Many of the biggest funds agree. Citadel, the $20bn hedge fund, has gone the furthest to protect itself from problems, raising debt from the private bond market. But others have taken term loans from big banks such as HSBC, or set up daily "sweeps" to remove from their prime brokers assets not being used as collateral.

For the highly profitable prime brokers, this loss of assets would be terrible news if extended across the industry, pushing up their funding costs and hurting what for many banks was the most profitable division in recent years.

Ideas being bandied about by hedge funds could be even worse news. Some are considering whether assets could be kept secure at custodians, with the broker given a charge over those it lends against - making the assets safe from a bank collapse by blocking rehypothecation altogether.

Others wonder whether prime brokers could set up a segregated custody division, something which appeals to managers who doubt the capability of established custodians, but trust their prime brokers.

Even if there is no dramatic change to the business model, prime brokers face a less profitable future and hedge funds will have to pay more for less generous leverage. If investors get their way, that cost will be even higher - but at least there will be less chance of funds being destroyed by a catastrophic bank collapse.

Fonte: Financial Times, London, September 25 2008, Companies & Markerts, p. 33.