

prime brokerage

Not Just for Equities
and Fixed Income
Anymore

Supporting derivative products is a growing trend in prime brokerage. As the hedge fund community continues to expand and its strategies have diversified to include derivatives, prime brokers have added OTC products to their product scope to allow clients to continue to streamline their operations.

OTC derivatives processing is manually burdensome and prone to expensive errors for lean buy-side operational teams. Equally important, clients can realize significant margin savings by having one counterparty that recognizes their offsetting portfolio positions. Derivatives prime brokerage gives portfolio managers the ability to trade complex instruments with multiple counterparties while continuing to have a streamlined back office.

History of OTC Derivatives Prime Brokerage

OTC derivatives prime brokerage began in the FX market. Hedge funds trading foreign exchange as a strategy wanted to have the same operational relationship with their dealers as they had in the equity and fixed income markets. As a result, a multidealer intermediation model was created for the FX market, whereby prime brokers act as principal on all trades executed by the client. With this approach, clients can keep multiple execution relationships, but have one legal counterparty for credit and settlement purposes. As FX prime brokerage has matured, the product scope has grown from simple FX spot trades to vanilla and exotic FX options.

Given the success of prime brokerage in the foreign exchange market, the multidealer intermediation model has been extended to the interest rate and credit derivatives markets. Prior to prime brokerage, traditional equity and fixed income prime brokerage clients would have to concentrate all their derivatives trading with their prime broker or negotiate an ISDA with each execution counterparty. The primary benefits of OTC derivatives prime brokerage are similar to those in FX, but they are magnified due to the complexity of the interest rate and credit derivatives markets.

Benefits of OTC Derivatives Prime Brokerage

Best Execution

Principal intermediation allows clients to access liquidity and the best prices. Since derivatives are more credit intensive than other financial products, prime brokerage has made derivatives markets more accessible for clients that do not have the operations, legal or credit infrastructure to participate effectively in the derivatives market.

Portfolio Margin and Operational Efficiency

Using a simple scenario, clients that use a single prime broker have one settlement counterparty for all of the trades that they transact. When one considers the alternative of having numerous bilateral relationships — all which require operational management and independent margin — the benefits quickly become apparent.

First, prime brokers can offer significant margining benefits to their client because all trades in are in one portfolio and offsetting positions can be recognized. In addition, by having a single counterparty, the client eliminates the risk of margin valuation differences or timing differences between two bilateral counterparties that hold offsetting positions from the client's portfolio.

Prime brokerage clients generally receive greater focus and attention operationally. Clients are usually assigned a client service representative who develops in-depth knowledge of their activity and acts as a single point of contact at the firm for day-to-day issues affecting that client. By focusing on a single operational relationship, clients can develop a strong working relationship, which is of great importance if problems arise.

The difficulty with maintaining multiple relationships is that clients have to cope with inconsistent processes and levels of service among counterparties. Under a prime brokerage arrangement, clients should achieve consistent settlement and confirmations, improved cash management and collateral servicing, and consolidated reporting.

Leading prime brokers have developed electronic solutions that enhance processing efficiency, minimize operational risk and provide added-value services. The goal is to process most transactions electronically using a secure messaging format with direct integration to and from a client's system. To further maximize straight-through processing, prime brokers have integrated with the wider community of executing banks and fund administrators.

Summary

The extension of OTC derivatives to the portfolio of products that prime brokers support brings great benefits to clients, especially margin efficiency and operational reliability. Such benefits should give clients the confidence to diversify into derivative products if they are appropriate for their trading strategies.

JPMorgan Prime Brokerage

Organized as a single global business, JPMorgan Prime Brokerage offers clients a seamless, integrated experience across multiple geographies and asset classes, from the first meeting to the final trade reconciliation. As a leading execution counterparty in global markets including derivatives, fixed income and foreign exchange, we also offer clients the confidence of one of the most creditworthy counterparties on each trade.

JPMorgan offers full principal intermediation for OTC derivatives and foreign exchange with the ability to net offsetting positions. With a global, 24-hour coverage model, you have a responsive contact available when you need one. ○○○

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