Credit woes highlight new demands on service providers

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Firms that provide services to hedge funds are changing the way they do business, and the reason is institutional investors. As these investors allocate increasingly large sums to hedge funds, they view the quality of service provision as an important aspect of risk management.

These investors come with a high level of requirements, according to Fortis Prime Services' Western Hemisphere head Jacques Bofferding. They want net asset values determined more frequently, without delays and errors, and to have a clear view of all that follows once a trade is placed at the manager's end. Says Bofferding: 'They are raising the bar - they want to make sure their money is in a safe place and will return.'

While the instinct for preserving capital is nothing new, it is particularly crucial right now. Investment banks have already suffered USD190bn in losses linked to the sub-prime meltdown and are far from done yet, with some forecasters suggesting that total write-downs could escalate to as much as USD600bn. Global markets, meanwhile, have seen significant falls, claiming many hedge funds as casualties.

Practitioners say the problems are intensifying. Amid the unfolding credit crisis, leverage is adding to industry woes. While the going was good, prime brokers and other lenders were quick to offer credit to funds to enable them to juice up returns, especially in strategies where profit margins are wafer-thin.

With asset values falling, leverage has amplified losses, pushing investors to the exit in droves. Banks are making new lines of credit scarcer and pricier and are calling back outstanding loans or raising margin requirements. This credit squeeze is forcing managers to sell assets in order to raise cash, but buyers are scarce even for what are still deemed good quality assets, sending prices still lower.

'The liquidity crisis is one of the biggest we've seen in a long time,' says Karim Leguel, investment chief of asset advisory firm Rasini & Co in New York. 'Banks and brokers are in distress due to regulatory arbitrage involving structured products, and this affects everyone,' he says, referring to their use of off-balance sheet vehicles to avoid having to set aside capital to meet adequacy requirements. There is zero tolerance for error in current markets, he argues.

On the accounting front, valuation of assets is also proving difficult. Hedge fund investments have increasingly branched out into exotic securities, which are complicated to value at the best of times. Compounding these problems, the future still looks murky for US real estate, which is at the core of many of the structured products that are under water.

'On the fixed income and asset-based lending side, lack of transparency is a concern,' says Campbell Harvey, professor of finance at Duke University's Fuqua School of Business. 'Investors are wondering how much more bad news is yet to come.'

In this fraught economic landscape, investors are bracing for the worst and hoping that at least their funds' service providers are on the ball.

Merrill Lynch's prime brokerage business, which ranks third behind Goldman Sachs and Morgan Stanley in industry rankings, is well prepared to handle current challenges, according to Jeff Penney, co-head of Merrill's global markets financing and services business.

'The current market adversity is playing to our advantage,' he says, claiming that Merrill has picked up a number of new clients in recent months as hedge funds move away from the traditional model of having just one prime broker to a multi-prime system.

'Global prime brokers like ourselves are being added to hedge funds' prime broker lists, because they are seeking to diversify their investments both geographically and by asset class. Hedge funds see the benefits of having a diversified portfolio of global assets.'

Merrill Lynch has hired selectively this year, a period during which some of its biggest rivals, like Morgan Stanley, have lost senior prime broker bankers.

Penney says Merrill has expanded its infrastructure and offerings to meet the growing needs of the market. For example, it launched the Merrill Middle Office Solution with hedge fund administrator GlobeOp late last year for hedge fund managers with more than USD1bn in assets, touting benefits that include efficient data aggregation and trade reconciliation along with compatibility with other prime brokerages.

Merrill also sees interesting growth opportunities in electronic access to markets along with prime brokerage custody and finance, and is focusing on Asia and Eastern Europe as key regions for expansion, Penney adds.

Some of Merrill's rivals, including Citigroup and Credit Suisse, have also invested heavily to build technology that can host multiple primes. This trend is expected to continue despite a recent US General Accountability Office report finding that the increasing use of multiple prime brokers was fraught with risk, since no one institution had the full picture of a fund's risk exposure.

Industry participants, however, take issue with the report's conclusion. Multi-prime is a necessity and not a matter of choice, according to Stuart Feffer, who with Christopher Kundro heads Cargill subsidiary LaCrosse Global Fund Services, which administers USD14bn in assets.

'Most people I speak with in the market are very concerned that balance-sheet issues and credit exposure concerns at the banks could lead them to change the availability of collateral and lending terms on short notice,' Feffer says. 'Therefore many fund managers are making sure they have several different prime broking and financing relationships.'

While the GAO's report purely highlighted concerns and did not make any recommendations, it might feed into a separate report being prepared by the President's Working Group on Financial Markets.

Even so, the report crystallises the idea that counterparty risk should be a primary area of focus, according to Judith Gross, principal at compliance consultancy JG Advisory Services in New York. 'Market players as well as regulators will certainly use this report as a roadmap for planning their future programmes,' she says.

'The report was also significant because it mentioned the importance of proper disclosure in risk reduction - that is, potential investors should be aware of risks associated with a hedge fund investment, but often they do not understand those risks.' Gross expects hedge funds and their counterparty risk to come under greater scrutiny.

Administrators are also increasingly in the spotlight. Both managers and investors demand predictability of good service and scalability of operations from their providers, according to Akshaya Bhargava, who heads Bermuda-based fund administrator Fulcrum. Due diligence processes are becoming much more rigorous, says Bhargava, who took the helm at Fulcrum after his former employer 3i invested USD57 million in Fulcrum last June.

An administrator not only has to demonstrate competence in its work, but must show strength in its own operational management, he says. Fulcrum, which serves its clients around the clock from offices in India, Ireland and Canada, is focusing on building out its middle office offerings and has automated procedures so that the same work can be done seamlessly from anywhere in the world.

Sigma Partnership's managing partner Joe Seet expects institutions to demand higher governance standards from managers, with the role as gatekeepers carried out by independent fund directors. As a result, administrators are not putting their executives up to be board members due to the obvious potential for conflicts of interest.

'The competition for funds is so intense that both prime brokers and fund administrators are looking for more value-added services to differentiate themselves from the competition and to provide a one-stop shop for the customer,' says Scott Alderson, president of New York-based Paladyne Systems, which sells front-to-back technology offerings to hedge funds and administrators. Some of the additional services include daily reconciliations, technology offerings, risk management and aggregated reporting, he says.

These factors are contributing to the rise of specialist service vendors such as CorrectNet, which provides services that aggregate data from different sources and offers data management and reporting applications to hedge fund managers. There's a growing need for sophisticated client reporting and transparency, according to chief executive Robert Miller.