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The new order in the prime brokerage industry

This month, we want to bring to you a review of the prime brokerage industry performed by one of our intern from Villanova University, Kunj Amin. The table provided at the end of the review is a good due diligence tool for those who would like to assess the counterparty risk in their hedge fund portfolio.

The Fall of 2008, its events concerning the global security and equity markets, and their ongoing ramifications have caused considerable change in the way investors now evaluate banks when it come to prime brokerage. If this is not the case, then those investors *should* be reevaluating their prime brokerages to see if they truly are capable of keeping their money safe. Ironically, the Pershing Division of the Bank of New York Melon conducted a survey during the summer of 2008 attempting to assess counterparty risk from the perspective of hedge fund managers. Their results seemed to destroy the notion that counterparty risk is trivial as 50 percent of respondents viewed counterparty risk to be "extremely important" and 51% actually monitored it on a daily basis. Counterparty risk was even found to be the most important factor when evaluating a prime broker.

The prime brokerage industry has also been shaken up by the exit, entrance, and strengthening of multiple players which has given us a substantially different environment to work in. Firstly, both Lehman Brothers and Merrill Lynch exited the prime services market when they collapsed, at least in part. Lehman Brothers' North American prime services segment was acquired by Barclays Capital and Bear Sterns' operation was taken over by JP Morgan Chase. Meanwhile, Merrill Lynch and Bank of America merged. HSBC further complicated matters by introducing a prime brokerage service of their own last month. Credit Suisse and Deutsche Bank were both ranked as the top prime brokerages of 2008 by an annual survey of hedge funds conducted by Global Custodians magazine.

The table below summarizes the most recent credit ratings provided by S&P, Moodys and Fitch to the major players in the prime brokerage universe. The table also include those institutions tier 1 capital ratio as provided in their 2008 financial statements.

The lowest rated financial institution in our table is Morgan Stanley for all the three rating agencies. The best companies according to S&P, in terms of financial strength, are BNP Paribas and Barclays Capital followed closely by JP Morgan and HSBC.

	S&P(Q1 2009)			Fitch(Q1 2009)			Moodys (Q1 2009)			Tier 1 Capital Ratio (2008)
	Long Debt	Short Debt	Outlook	Long Debt	Short Debt	Outlook	Long Debt	Short Debt	Outlook	
JP Morgan	AA-	A-1+	Negative	AA	F1+	Stable	Aa1	P-1	Negative	10.90%
Credit Suisse Group	A+	A-1	Stable	AA-	F1+	Negative	Aa2	P-1	Negative	13.30%
BNP Paribas	AA	A-1+	Negative	AA	F1+	Negative	Aa1	P-1	Negative	7.80%
Goldman Sachs Group, Inc	A	A-1	Negative	A+	F1+	Negative	A1	P-1	Negative	15.60%
Deutsche Bank AG	A+	A-1	Stable	AA-	F1+	Negative	Aa1	P-1	Negative	10.10%
Barclay Capital	AA	A-1+	Negative	AA-	N/A	N/A	Aa3	N/A	Stable	9.70%
UBS AG	A+	A-1	Stable	A+	F1+	Stable	Aa2	P-1	N/A	11%
HSBC Holdings PLC	AA-	A-1+	Negative	AA	F1+	Negative	Aa2	P-1	Negative	8.30%
Citigroup	A	A-1	Stable	A+	F1+	Stable	Aa3	P-1	Stable	11.90%
Morgan Stanley	A	A-1	Negative	A	F1	Stable	A2	P-1	Negative	n/a