acuiti management intelligence

The future of Prime Brokerage: How buy-side demands are creating opportunities for new entrants

IN ASSOCIATION WITH

TS IMAGINE™

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Introduction

For a given prime brokerage, a single client can generate diversified, recurring revenue streams across securities lending, margin financing, custody, and trade execution. Despite its high fixed cost-base, the ability to run multiple revenue lines, amortise fixed costs, scale balance sheet and capture long-term recurring and relationship-driven revenue are highly attractive benefits.

However, for the investment banking industry, capital requirements are a core consideration across business lines. Whether prime brokerage, clearing or execution, banks are now much more selective about the clients they work with under Basel III restrictions.

Following the implementation of Basel III, many hedge funds experienced reductions in financing lines or, in some cases, a withdrawal of services, often across multiple prime brokers.

The introduction of more stringent capital and funding constraints under the framework has driven much of this shift, by increasing the balance sheet cost of financing client positions. As a result, prime brokers have adopted a more selective and returns-driven approach to client coverage.

An underwhelming decade for hedge funds in the 2010s fortified this approach. With annualised returns of around 4% and about 50bps of alpha, according to Barclays research, the industry was not an exciting proposition for many.

In part, the loose monetary policy of the time drove this trend, with central banks' imposition of zero interest rate policy and quantitative easing contributing to supressed volatility across asset classes.

However, that trend has reversed spectacularly in recent years and the industry recorded an 11.2% average return last year, according to Barclays. Rising interest rates and volatility have helped resurrect opportunities to harvest uncorrelated alpha.

This has led some market participants to herald a golden era for hedge fund returns. Inflows have followed these fortunes, with the industry growing beyond $5 trillion AUM in the last two years, according to Barclays.

While these flows have benefited existing players, optimism is also driving new funds to launch. Hedge Fund Research estimates that 562 new funds launched in 2025, the highest level since 2021, while liquidations were estimated at 287, near historic lows. Increased client flow is therefore running into a restricted prime brokerage offering.

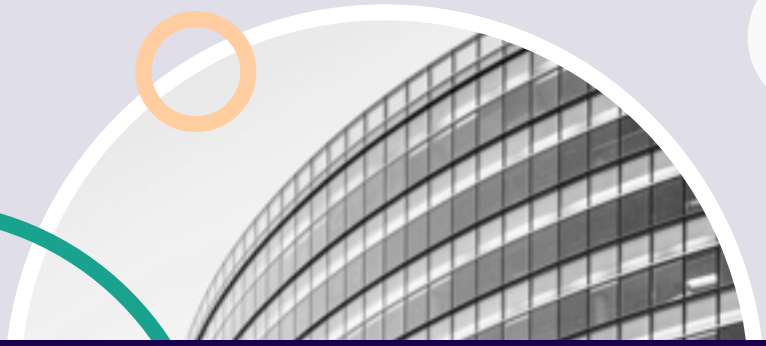
At the same time, hedge fund demand is becoming increasingly sophisticated. Rising interest rates are also driving an intense focus on capital efficiencies, which is spurring new conversations about collateral management and margin optimisation.

This has created opportunities for new entrants to service smaller AUM funds, or asset classes on which larger prime brokers are less focused. The same opportunity exists for established prime brokers with balance sheet capacity to ramp up operations and target new corners of the hedge fund industry.

However, despite some new entrants, access to prime brokerage for hedge funds remains uneven. Funds running strategies in asset classes other than equities have reported obstacles to accessing the full suite of prime brokerage services.

To examine the precise nature of buy-side demand and how prime brokerage units can adapt to meet it, Acuiti has partnered with TS Imagine to survey and interview senior executives from hedge funds and prime brokers.

Of the 56 survey respondents, all of whom work at hedge funds, 47% are based in Europe, 30% in North America, 13% in APAC and 6% from MEA.



The key findings are:

- 55% of surveyed firms have experienced multiple leverage reductions or tightened margins during the past five years
- Margin is becoming an increasing focus for hedge funds, with haircut negotiation, responsiveness to margin relief requests and clarity and consistency of margin methodology all emerging as points of frustration
- 57% of surveyed firms have switched or considered switching their prime brokerage due to changes in financing costs or leverage
- Levels of satisfaction with traditional value-add prime broker services are down across the board, with firms giving notably negative views on capital introduction, investor due diligence and research and intelligence

How the buy-side views prime brokerage

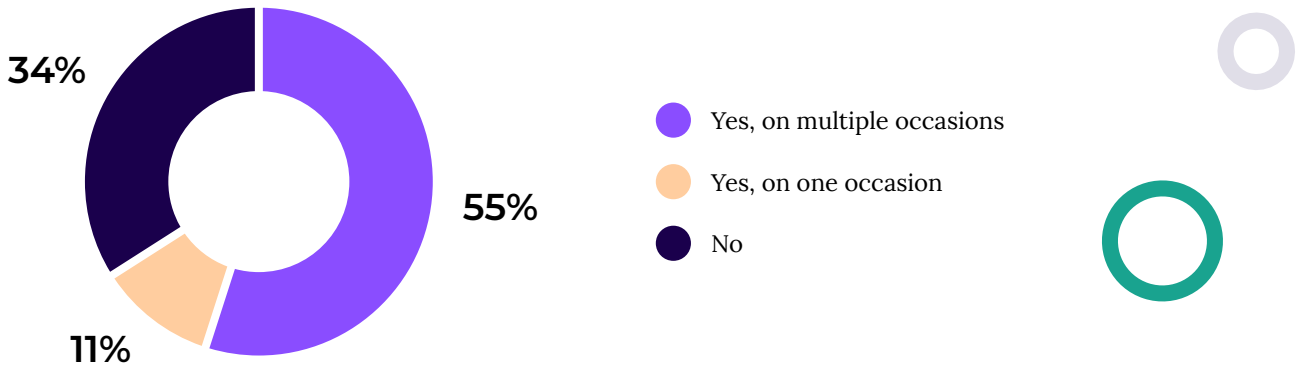


Most surveyed buy-side firms have had to deal with reduced leverage or tightened margin requirements over the past five years. For more than half, it has been a repeat occurrence. In part, tightened prime brokerage services are a function of market volatility, but they also reflect debate with bank risk departments and the limits that CCPs impose.

However, the story is also one of asset class inequality. This determines the ease for a hedge fund of accessing leverage. In this hierarchy, funds with equity trading lines have access to a broader selection of prime brokers and generally higher multiples of leverage.

Meanwhile, for hedge funds that trade a pure credit or commodities strategy, leverage can be harder to access. This is either due to fewer prime brokers that service the asset class or because the tools available to achieve leverage are more limited. For example, a credit trading desk might offer a total return swap, but not other forms of leverage.

Has your prime broker reduced leverage or tightened margin requirements in the past five years?



In part this is a function of some prime brokerage units at tier one banks sitting on equity trading floors. As a result, some desks will only offer their leverage to funds with some level of equity revenue, to the detriment of firms that only trade credit, for example.

More broadly though, equity is an easier asset class to internalise. Internalisation is the practice of using one client's collateral for another client's trade. A classic example of this is a prime broker delivering the equity posted as collateral for a margin loan by one client for another's short position.

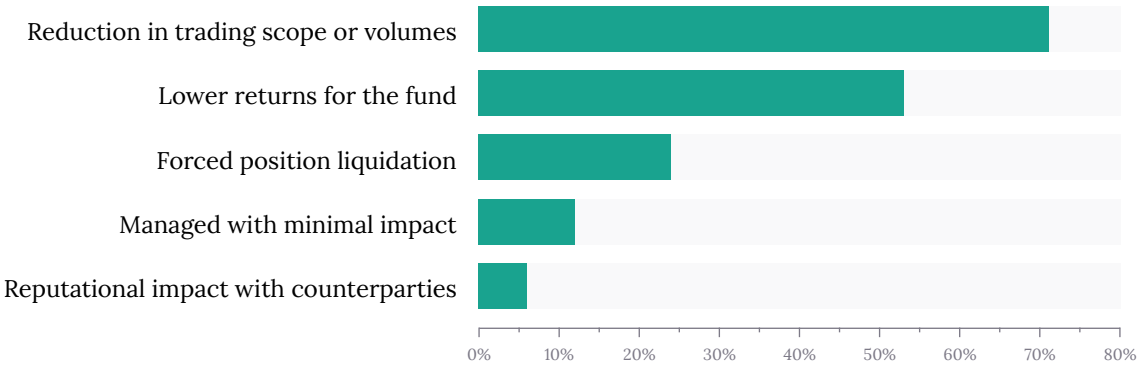
Because of this, a well-diversified and market neutral trading strategy can gain generous access to leverage.

For other strategies such as the basis trade, access can become complex. Following the basis trade example, if one leg of the trade is an exchange-traded future and the other a cash equity, internalisation will be challenging as each leg will be executed through different trading venues and workflows.

Whatever the cause, leverage or margin tightening can have a significant impact on buy-side operations. Most survey respondents reported suffering a reduction in trading scope or volumes, as well as lower returns for the fund, when their prime broker reduced leverage.

Over the long term, events like these can significantly hamper a fund's ability to quickly exploit market opportunities and ultimately, deliver full value to their shareholders.

How did the reduction in leverage impact your firm?

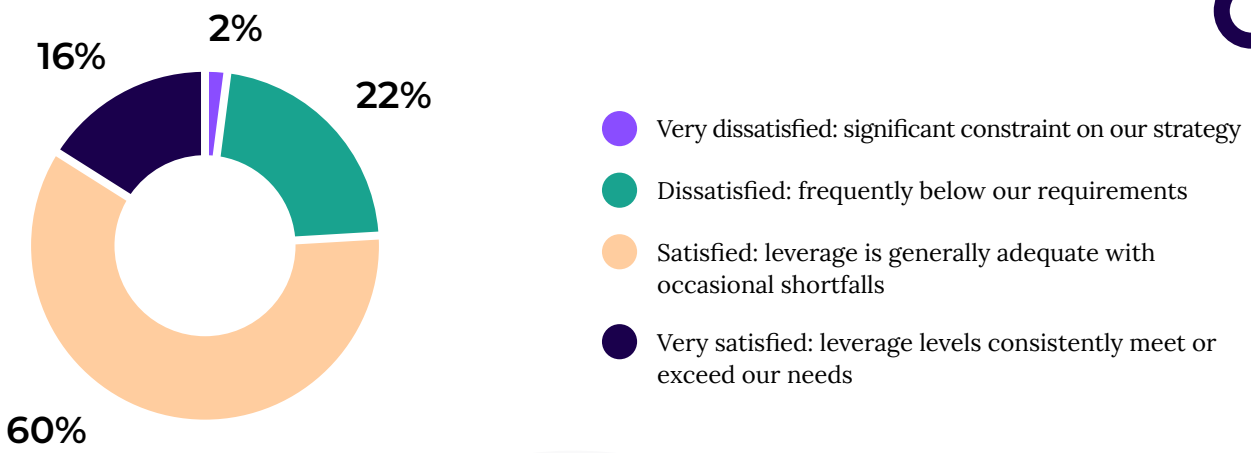


These factors, as well as diversification considerations, help explain the common pattern of maintaining multiple prime brokerage relationships. Only 9% of hedge funds in the survey operated a single prime brokerage relationship. Seventy-three percent used more than three prime brokers.

Despite multiple prime broker relationships, just 16% of the firms surveyed said that the leverage available to them consistently met their needs. Nearly a quarter were dissatisfied or very dissatisfied.

Broadly though, surveyed firms showed satisfaction with the leverage available to them – a view held by 60% of respondents. This, and the frustrations described above, suggest that while, for the most part, hedge funds have found a route to some form of leverage in the world of Basel III, offerings can be limited in scope.

How satisfied are you with the overall level of leverage your primary prime broker is willing to extend to your firm?

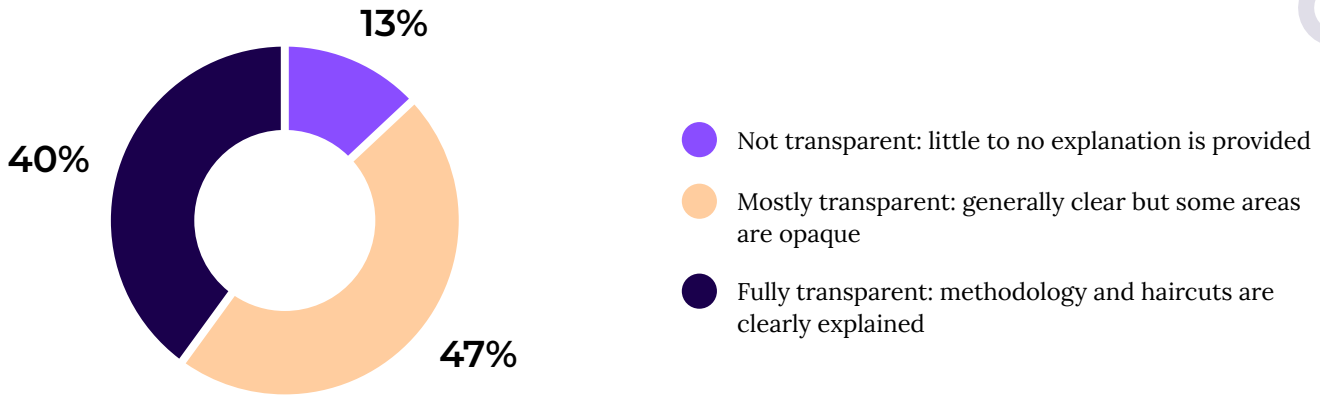


In the face of a buy-side with increasingly sophisticated demands, this is posing new challenges for the prime brokerage model.

One example of this trend is growing buy-side demand for greater transparency into how leverage allocation is determined.

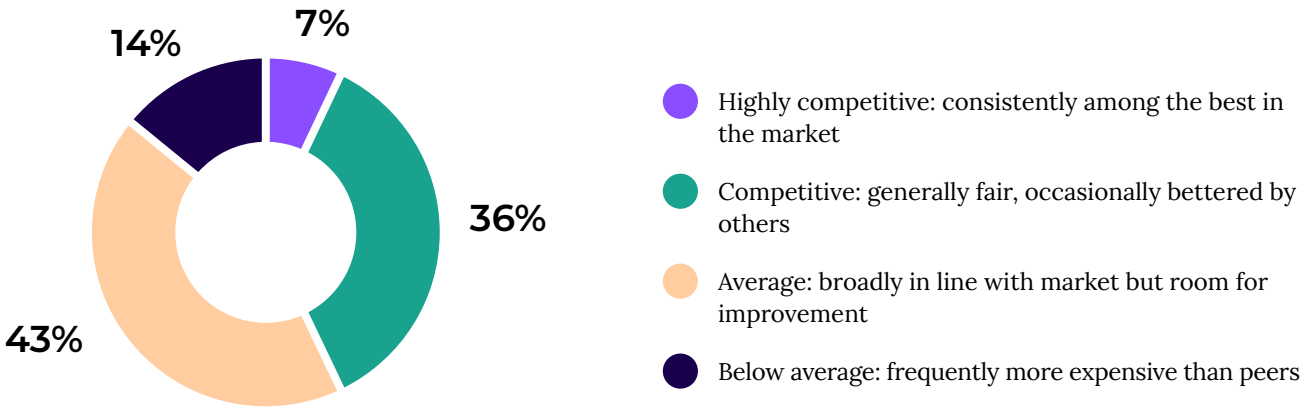
Overall, 60% of respondents had some level of frustration in this process.

How transparent is your prime broker in communicating the factors that determine leverage?



There are also concerns in firms' assessment of the financing rates that their primary prime broker offers to them. While 43% said that their prime broker's rates were competitive, 57% said that the offering had room for improvement or was often more expensive than their peers. Smaller firms found this issue particularly acute.

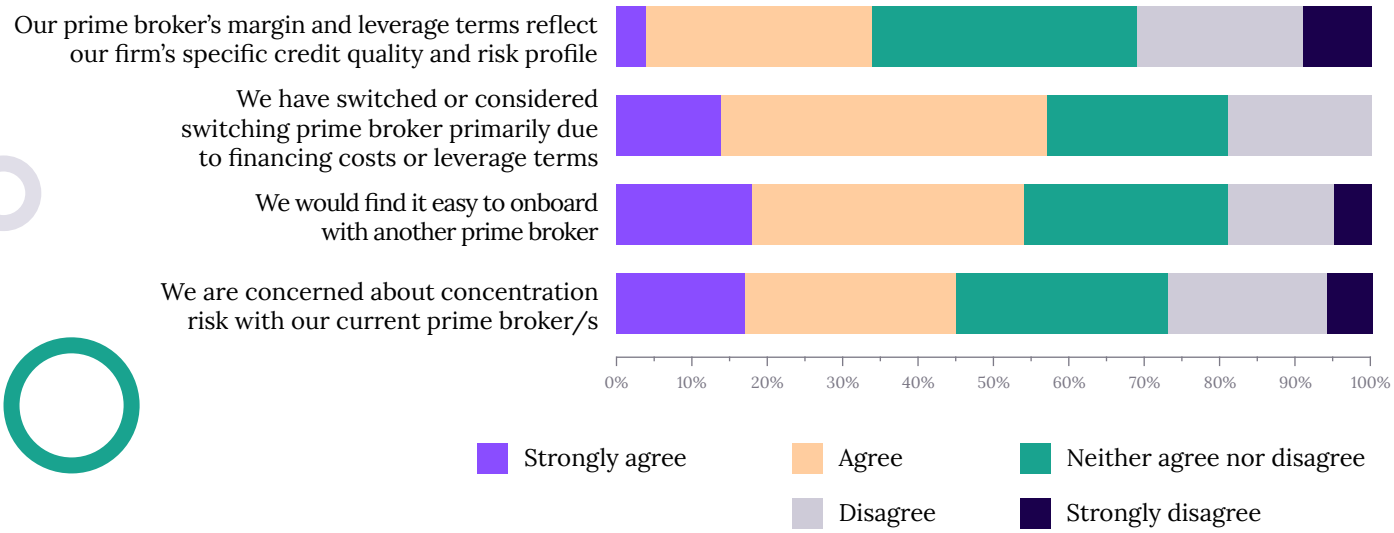
How competitive are the financing rates offered by your primary prime broker?



Access to leverage and competitive financing rates are core functions of prime brokerage and despite the traditionally sticky nature of client demand in the business, 57% survey respondents said that they had either switched or were considering switching their prime broker due to financing costs and leverage.



Do you agree or disagree with the following statements:



Change risk did not come through as a major preoccupation. Most surveyed firms were comfortable with changing their prime broker to achieve better financing or leverage terms, and 55% said they would find it easy to onboard with another prime broker.

These findings suggest that despite the scale advantages of being a tier one prime brokerage, there is demand for more niche aspects to leverage services and significant opportunities for firms entering the market.

While prime brokerage works well for many equity-focused hedge funds, it is less complete for managers operating across non-equity asset classes, where financing, collateral, margin, lifecycle management, and operational workflows are often more fragmented.

A second limitation is the lack of integrated tools to manage the full operating model of a hedge fund across financing, collateral, margin, exposure, liquidity, corporate actions, reporting, and risk.

Leverage is part of this problem, but it is best understood as the outcome of several connected inputs, including margin requirements, financing terms, collateral eligibility, portfolio composition, concentration risk, and the prime broker's own risk appetite.





The new frontiers of prime brokerage

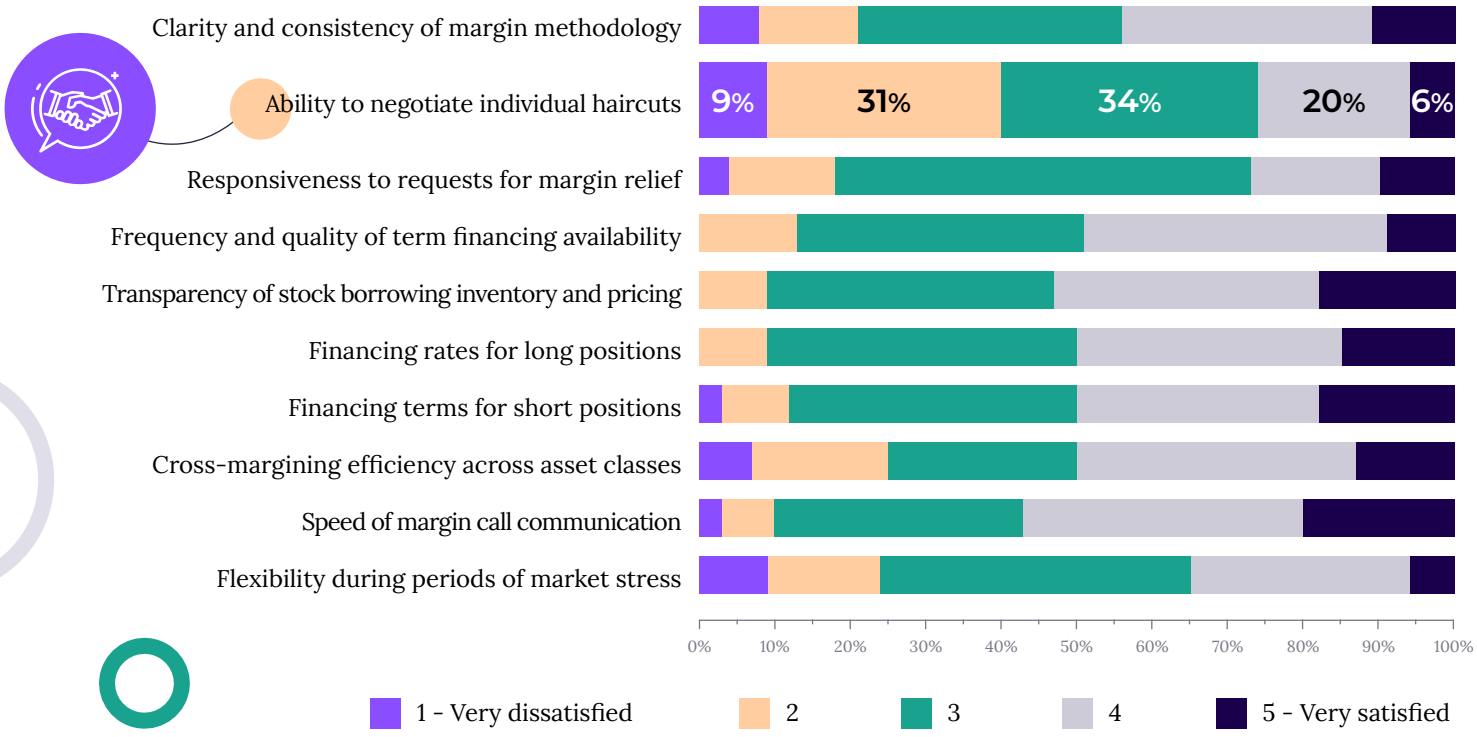
1. Margin

Margin has been an area of focus for the buy-side in recent years, as hedge funds in particular look to make their trading operations as efficient as possible.

Interviews conducted for this research suggest that the key divide in the hedge fund market is not simply the availability of leverage in aggregate, but the ability of managers to analyse, challenge, and negotiate financing, margin, and collateral terms with their prime brokerage counterparties. This increasingly separates funds with the systems, data, and expertise to manage these discussions in detail from those that remain more constrained. As with leverage, this divide often correlates with size, as larger hedge funds are typically better positioned to dedicate the resources required for this level of analysis and negotiation.

While survey respondents were satisfied with many elements of their margin set-up, such as the speed of margin call communication, frustrations emerged around other aspects, such as their ability to negotiate individual haircuts and prime brokers' responsiveness to margin relief requests. Clarity and consistency of margin methodology also emerged as a frequent frustration.

How satisfied are you with the following aspects of your prime broker's financing and margin terms?



Margin methodology has been a point of conflict between hedge funds and their prime brokers since post-crisis reform made it central to balance sheet management. Historically, this was not an issue. Clients mostly accepted their FCMs' margin calls in good faith. In recent years though, greater scepticism has crept into this dialogue. More buy-side firms are conscious that sell-side calculations could disadvantage them.

CCP margin models provide a baseline, but prime brokers often apply their own risk appetite and balance sheet considerations and may challenge CCP margin.

The resulting margin applied to hedge funds is therefore not always a direct reflection of CCP requirements. Reductions in CCP margin are not always transmitted to clients and that, along with more readily applied increases, has led hedge funds to further scrutinise how margin is calculated and adjusted.

The trend has only gained momentum with hedge funds' greater institutionalisation. Some firms can now claim to have more sophisticated risk management processes and tools than the banks that service them. These market participants are typically highly focused on capital efficiency.

The need for transparency drives these developments. This plays out in attempts to understand margin methodologies and anticipate how and why larger margin calls arrive. It is also increasingly motivating demand for cross-margining efficiencies against different asset classes.

True transparency requires a holistic view of margin, and as most hedge funds will have more than one relationship with a prime broker, firms have reported challenges when trying to obtain this information from their prime brokers. While some are reportedly more willing to provide this information, others have been known to refuse the request.



2. Data quality

High-quality data is an essential ingredient to better analyse margin, and indeed for much of modern financing infrastructure. While managing trade lifecycle data is a challenge in most corners of investment banking, the prime brokerage structure creates unique obstacles to achieving this.

Prime brokers operate in an interweb of connectivity between client, prime broker, venues and clearing houses, which elevates the potential points of failure between these interfaces. Multiple ownership claims on each security that the unit usually handles add to the complexity.

Data management, the process of rationalising, streamlining and safely storing a firm's data, also involves dealing with markets that are in different stages of electronification.

This creates challenges in reconciliation, data handling and processing that are applicable across the trade lifecycle, with corporate actions proving a particularly acute pain point for prime brokerage units.

A corporate action affecting just one security being used within a prime brokerage can cascade across multiple funds, as well as impacting the prime brokerage itself. Because one security can have multiple use cases through the use of rehypothecation or securities lending, the sequence of payments that a corporate action triggers can quickly become complex and costly, if processing errors occur.

As more firms use artificial intelligence to resolve administrative pain points such as trading limits, the importance of data quality will increase, as it is fundamental to AI models' perfomance.

3. Value-added services

With margin and data quality emerging as key new focuses, it is worth considering how firms view the traditional value-added services that come with a prime brokerage offering. Here, ratings were consistently poor, with no service ranked more positively than negatively.

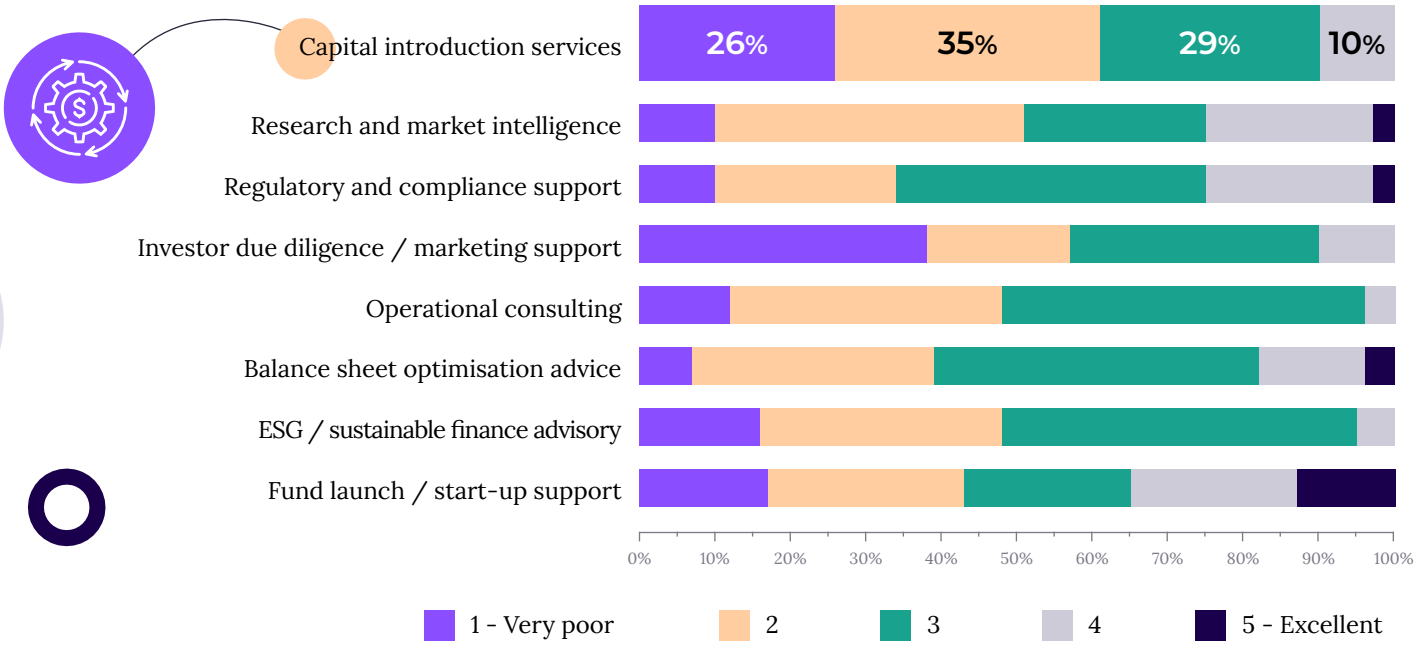
Opinion was particularly down on capital introduction and investor due diligence. Firms also saw research and intelligence in a strongly negative light.

Even though interviews backing this research indicate that capital introduction is still a highly desirable service for funds, especially smaller ones, many banks have found it hard to justify internally.

Management will often prize larger clients that they see to be higher volume participants and less risky.

With the rising power of a select number of large buy-side firms, senior management are often more focused on winning business from this smaller group of clients then supporting smaller funds.

How would you rate the value-added services your prime broker provides beyond core execution and financing?





Conclusion

Prime brokers' ability to provide leverage to hedge funds has largely survived the impact of Basel III. However, beyond an aggregate view of broadly available leverage there are kinks in both the scope of leverage across asset classes and the sophistication of tools to fully analyse leverage.

As with any market inefficiency, this situation creates opportunities for new service providers.

For hedge funds with lower AUM, or those running more niche strategies, prime brokerage services are often constrained. This is particularly true with leverage and financing but there are other services that the buy-side is looking for from their prime brokers that are currently under-served.

This presents an opening for new firms, and those with the balance sheet capacity to explore new client bases, to provide prime brokerage services. Hedge funds trading narrower asset classes, such as commodities, prize focused expertise in these markets.

Being able to expand value added services and data and analytics are also strengths. These are significant areas where sections of the hedge fund industry need more specialised and complete service.

There is another broader opportunity in the space though, that is tied to recent technological evolutions. As margin management becomes an increasingly important issue for hedge funds, demands for greater transparency and high-quality data sets will grow.

As such, prime brokers and hedge funds face a future in which quantitative tools become ever more important, as market participants seek to analyse every step of the trade lifecycle to find efficiencies.

As the provision of traditional value-add services, such as capital introduction, declines, these are fronts where firms will win market share in the next phase of prime brokerage competition.





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