FX·Markets

FX prime brokers jockey for buy-side flows as IM phase 6 looms

Banks say concentrating trades through single dealer would ease paperwork logjam for asset managers

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26 Oct 2021

Foreign exchange prime brokers are reporting an uptick in interest from asset managers looking to avoid a documentation crunch when the final phase of initial margin rules kicks in next year.

An estimated 800 mainly buy-side entities will be required to post initial margin on non-cleared derivatives – including FX options and non-deliverable forwards – starting from September 1, 2022. Observers have long warned of a **bottleneck** in legal paperwork as firms scramble to open custody and collateral accounts, among other documents, in time for the deadline.

While some companies have looked to use a regulatory reprieve that allows them to **hold off** posting margin until their derivatives exposure with a single counterparty cross a **€50 million threshold**, FX prime brokers say they are fielding enquiries from asset managers looking for a way to minimise their legal efforts.

"What we see is a huge backlog in getting that documentation – the custody and collateral arrangements – all put in place. Setting it up is heavy, but also managing it is a heavy overhead because you're having every day to post margin on all of those," says Marcus Butt, global head of prime services and futures at NatWest Markets.

Tom Arnold, head of sales at Record Currency Management, says they are seeing broader interest in FXPBs from asset managers, as well as pension funds, endowments and foundations.

Asset managers have traditionally not needed to use FX prime brokers, as dealers were content to trade bilaterally with them owing to their lower counterparty credit risk. But prime brokers are renewing their pitch to buy-side firms to route all their non-cleared derivatives trades that require initial margin through a single broker counterparty, through which they can access liquidity from all their usual dealer sources.

The benefit to the client is that they would only need to set up initial margin and custody documentation with the prime broker, and not with every one of their current relationship banks – avoiding the documentation crunch in the process.

"To the extent that they can have a prime relationship intermediate all of that usually bilateral activity, basically new custodian account setups, it should make their lives easier," says the head of one European bank's FX prime brokerage. "That said, they do have to set up an FXPB agreement, they do have to set up an FXPB relationship. So, it's not a perfect offset, but there is some benefit."

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Marcus Butt, NatWest Markets

Concentrating their flow into a single counterparty would allow clients to net all their margin in one place – resulting in potential reduction of margin requirements and costs – rather than having to hold collateral against each liquidity provider. If netting down of exposures with one counterparty could get smaller buy side firms' FX derivatives gross notionals under the clearing threshold - currently set at €3 billion for FX derivatives in Europe - then they are also not obligated to regularly calculate their exposure under the initial margin rules, reducing operational efforts.

Prime brokers say they have been making this argument to asset managers for some years, and that the interest they are currently seeing from prospective clients is more of a trickle, rather than a wave. But they expect enquiries to increase as phase six closes in.

The head of a second Europe-based FX prime broker says clients previously viewed the benefits of a single counterparty as theoretical, and that the upfront work required to set up a prime broking relationship was "often prohibitive to do so".

"Whereas now, those who are – or will be – captured under non-cleared margin rules are seeing a change in their margin, operational complexity and costs. This definitely helped highlight a benefit of FX prime broking to clients – although maybe not as much as we thought it would," says the head.

The head of FX prime broking at a US dealer agrees that the potential for cost increases from the phase six rules has helped spark more interest than in the past: "We're having a few [conversations] with some of the asset managers, but it hasn't been some big rush at the door."

Michael DuCharme, a managing director in trading and operations at US asset manager Mesirow, says the firm has had an FX prime broking relationship for several years.

He says routeing all non-cleared trades through a single prime broker has pros and cons. One advantage is the reduced effort and time to negotiate the required documents, and less complexity in dealing with a single

counterparty. Although he says it's impossible to quantify the size of the benefits.

On the other hand, he says using just one prime broker for these trades means the manager is more likely to breach the €50 million initial margin posting threshold – if they used multiple counterparties, they could run an initial margin balance of up to €50 million at each dealer and not have to post margin.

He adds that where an asset manager is just one of several trading on behalf of an asset owner, if some or all used the same prime broker, they could unwittingly push the owner past the €50 million threshold with that counterparty.

Record's Arnold also notes that moving to a FXPB would generally require initial margin for FX products that do not currently require it in bilateral trading.

Ultimately, DuCharme says, the major driver for the decision is time: "A prime broker search can be a time-consuming effort. Starting now to look for a prime broker, evaluating bids, negotiating the prime broking agreement and then completing the non-cleared margin process would be a challenging goal to achieve by next autumn."

However, the European bank's FX prime brokerage head says that, despite the looming deadline, asset managers are not known for moving swiftly to adapt to incoming rule changes: "As a group, asset managers are generally quite slow to move. They tend only to move when there's either a crisis, regulatory change or because costs are going to be extremely impacted."

Editing by Alex Krohn

Update, October 26: This story was updated to include comments from Tom Arnold at Record

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