Clear Street®

Weighing Counterparty Risk

The need to diversify counterparties in a risk-weighted asset driven environment

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The Main Ideas

- Rising interest rates, increasing loan growth, and the recent squeeze on profits have led to falling common equity tier 1 (CET1) capital ratios at the largest US banks.
- Meanwhile, Risk Weighted Assets (RWA) continue to rise, which could limit available capital from large money-center banks for financing to hedge funds.
- This could lead to higher rates and/or rationing of balance sheet and services. Large hedge funds with highly liquid assets and/or low leverage will likely not be greatly affected by these trends.
- Funds running strategies that require more leverage or have harder to finance asset classes appear likely to face financing challenges.

Our Recommendations

- Understand and analyze the impact of funds' portfolios on Risk-Weighted Asset calculations as well as how the GSIB surcharge will affect funding counterparties' appetite for financing.
- Have a frank dialogue with your counterparties on their funding capacity and your profitability as a client.
- Consider the benefits of diversifying your counterparties, prioritizing less correlated providers.

Weighing Counterparty Risk

Summary

Rising interest rates, increasing loan growth, and the recent squeeze on profits have led to falling common equity tier 1 (CET1) capital ratios at the largest US banks while Risk Weighted Assets (RWA) continue to rise. The RWA increase, further fueled by the implementation of increasing discretionary surcharges for U.S. globally systemic important banks (GSIBs) could limit available capital from large money-center banks for financing to hedge funds, leading to higher rates or rationing of balance sheet and services. Large hedge funds with highly liquid assets and/or low leverage will likely not be greatly affected by these trends, but finding stable financing for strategies that require more leverage or have harder to finance asset classes appears likely to become more challenging. This may cause managers and investors alike to re-evaluate how they think about counterparty risk and for managers to broaden the types of financing counterparties they use to diversify and therefore mitigate counterparty capacity risk.

Background

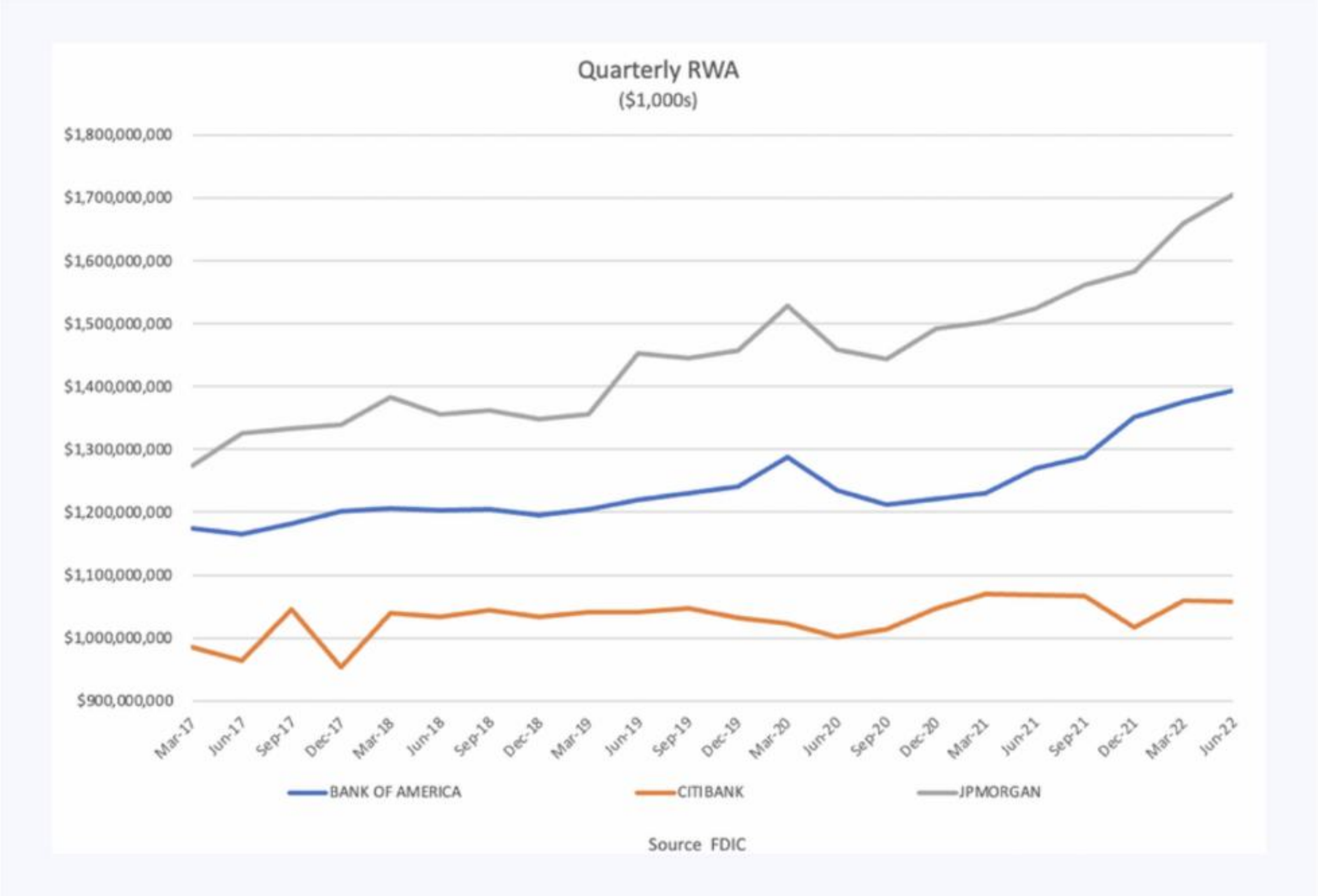
In the aftermath of the financial crisis, US bank regulators implemented a much more prescriptive capital framework, creating measurements including the Supplemental Leverage Ratio (SLR), and the even more restrictive enhanced SLR (eSLR) for Global systemically important banks (GSIBs). In 2014/15, as the market was coming to terms with these new constraints, many prime brokers found themselves with clients whose balance sheet usage and profitability were, to put it mildly, suboptimal given the new, binding eSLR constraints. These constraints changed prime broker behavior, limiting the capital made available to clients whose risk profiles didn't register attractively under eSLR or the Basel III-imposed CET1. As costs rose, tenors shortened, and other terms were made more onerous, many hedge funds found themselves renegotiating financing agreements and adding counterparties to ensure they maintained adequate financing. But after an adjustment period in which interest rates remained historically low and banks improved their ability to track and optimize balance sheet usage, demand for hedge fund financing balances increased and hedge funds and prime brokers settled into a lucrative equilibrium.

In 2022, however, that equilibrium is threatened. The pandemic upended much of the economy, but a (temporary) reprieve that permitted the removal of US Treasuries from the eSLR calculation extended the prime broker/hedge fund equilibrium for many. But with regulations and stress test calculations becoming more punitive, rising interest rates creating mark-to-market losses in bank portfolios that put further pressure on required capital ratios, and commercial loans increasing throughout 2022 until a very recent slowdown, many of the big banks who managed well to their eSLR constraints and gained market share in their prime brokerage businesses now find themselves considering counterparty balance sheet usage more seriously.

CET1 capital ratios were down for most U.S. banks over the first half of 2022, driven by declines in profits and rising interest rates. Morgan Stanley suggests the new stressed capital buffer will force many of the largest banks to cut risk-weighted assets in order to generate a CET1 ratio above the new required minimum. Citigroup is reportedly requiring some of its least profitable trading clients to post more collateral, or risk ending the trade relationship altogether. Meanwhile, RWA assets continue to rise, as seen in the chart on the next page.

This trend has been exacerbated by company-specific headlines. The most famous of these was the Archegos collapse, which left in its wake Credit Suisse, at the time one of the largest prime brokers in the world, exiting the business for good. Nomura closed its US and European Prime businesses, and other primes and their regulators were left rethinking the risks in the prime brokerage business model.

With large banks now increasing scrutiny on their prime businesses, finding more competing uses for capital in a rising rate environment, and facing less competition in the wake of the Archegos/Credit Suisse fallout, hedge funds, particularly those funds with less liquid portfolios full of more complex instruments with higher leverage needs, may face significant limitations and increased financing costs from their historic prime broker partners.



Our Analysis

The central operating question then, is whether this trend is a short-term blip that will revert as the economy normalizes postCOVID, or a long term sea-change that funds, brokers, and investors alike will need to reckon with and adjust best practices for. Our belief is that these trends are long-term, so funds and investors need to prepare for a world in which capital from large money center banks is more scarce. We believe this is the case because we feel the predominant binding constraint limiting bank balance sheets is in the process of an evolution.

Since its adoption, the enhanced supplementary leverage ratio has been considered the "binding constraint" on the balance sheet growth of banks, and thus a predominant restriction on hedge fund borrowing from larger banks.

A 2018 report from the Federal Reserve, updated in July of 2020, says exactly that, arguing that eSLR has superseded risk calculations as the predominant constraint in a post-BASEL III world:

> Consistent with regulatory pressures passing through to broker dealer clients' hedge funds adjust…splitting their business across a larger number of prime brokers and by reducing the overall size of their business. We argue that these changes are driven by regulation, in particular the supplementary leverage ratio (SLR), reducing the incentives for banks to provide balance sheet space to leveraged clients. The SLR requires that large financial institutions hold capital against their total leverage exposure, including on-balance sheet assets and off-balance sheet assets and exposures, with more stringent requirements for larger and more systemic institutions. Consistent with this hypothesis, we further show that the prime broker–client relationships change the most for prime brokers affiliated with global systemically important banks (GSIBs)…

And yet, over the past six years a kind of equilibrium was found between hedge funds and the large banks serving as prime brokers. Banks became better at specifically managing to the eSLR constraint. One way many banks and funds have managed to overcome this constraint is by turning to the sponsored repo market. Bi-lateral uncleared repo between banks and hedge funds directly hits the eSLR constraint.

However, centrally cleared trades, where both sides of a matched trade are executed by the same central clearing counterparty, can be netted off eliminating the impact on the eSLR. Sponsored repo enables “well-capitalized bank members” of the Fixed Income Clearing Corporation (FICC) to sponsor both cash lenders (money funds) and cash borrowers (fixed income and hedge funds).

The sponsored repo market has been an effective way for banks to continue to provide hedge funds US Treasury financing and has grown rapidly from $0 in 2017 to now trading a trillion dollars a day. However this comes at a cost. Sponsored bilateral repos, the vast majority of the sponsored repo market, are netted from calculating the eSLR constraint, but still add to risk-weighted assets (RWA) and so flows through to bank capital ratios.

This trend towards RWA becoming a constraint on hedge fund financing has been exacerbated by the Financial Stability Board’s (FSB) proposed changes to the GSIB Surcharge that is to take effect 1/1/2023. As an example, JPMorgan’s GSIB surcharge is increasing to 4% in 2023 and expected to increase to 4.5% in 2024. These regulatory changes have a real impact on capital allocation and returns of banks financing business. Implementing prior regulatory changes in the calculation of RWA for different lines of business caused JPM to increase the capital allocated to its corporate and Investment bank by 24%, from $83B on 12/31/21 to $103B on 1/1/2022.

Just last month, Jamie Dimon has argued that these restrictions are too limiting: “...regulatory capital minimum requirements already have JPMorgan Chase setting aside more than $200 billion in capital, which is in addition to loan loss reserves. In the coming months JPMorgan’s amount of required capital will increase not due to increased risk, but because long- needed adjustments have not yet been made to risk-agnostic size-based factors in parts of the capital framework, like the GSIB surcharge.”

He goes on to argue these limitations are bad for banks and bank customers alike, because they cause banks “to be capital constrained and reduce growth in areas like lending, as the country enters difficult economic conditions.”

We expect these trends to continue. In our estimation it is more probable that RWA, not eSLR, will become the binding constraint for growth. Just as client profitability had to be reevaluated in 2015/16 to adjust to the new world of eSLR constrained balance sheets, 2022/23 will likely see similar discussions between the large money center banks and their hedge fund clients.

Our Recommendations

In a volatility environment like our current one, which we project to endure, how should fund managers ensure adequate financing for a portfolio, especially when volatility increases? Large Funds with highly liquid portfolios with modest leverage will find their options much as they were before this change in environment. However, strategies that require more leverage or that hold harder-to-finance asset classes will likely find securing stable financing more challenging.

It is critical to understand the impact to RWA of these assets on the books of financing providers, as well as how the GSIB surcharge increase in 2023 will affect your counterparties' appetite to fund those strategies. The ability of Prime Brokers to measure both the profitability and the balance sheet usage of their clients has improved markedly since 2015/2016. Thus, have an open, forthright dialogue with your providers on your current profitability, how that may change, and their ability to service your needs in various volatility scenarios. Finally, consider diversifying your funding to counterparties with less correlated capital requirements.

Clear Street is subject to the same SEC Rule 15c3-3 client asset segregation and protection rules and reserve requirements as the large bank broker-dealer subsidiaries that provide prime brokerage services. However, it is not subject to bank regulatory capital requirements, nor the subjective and increasingly onerous constraints to funding hedge fund positions, and has dramatically increased its funding capacity both through capital raises and the issuance of A rated debt securities.

Citations

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