

# Prime Insight

Special Report from Scotia Capital Hedge Fund Consulting Group

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## THE CASE FOR A CANADIAN PRIME BROKER

Leading up to 2007-2008, the hedge fund industry, like global markets in general, experienced unprecedented growth. The climate of “irrational exuberance” was tempered when the excesses of the sub-prime mortgage sector began to finally become realized and no sector of the investment landscape was left untouched. A growing collapse of confidence in the system all but resulted in a modern day run on the banks. The “Too Big to Fail” principle was clearly debunked. Bear Stearns was the first to go down and the crisis quickly reached its heights with the collapse of Lehman Brothers. Many hedge funds that were receiving margin financing from Lehman could not recoup collateral when Lehman filed for bankruptcy due in part to the United Kingdom asset protection rules. The realization that such a large prime broker/custodian could collapse combined with developing concerns about the very stability of the banking systems in different countries/regions forced funds to rethink their counterparty risk paradigms and spread their counterparty risk across multiple prime brokers and across geographies. The world has changed.

The Canadian banking system has shown its resiliency charting a steady course through these troubled waters. Canadian prime brokers on the whole weathered the storm and continued to provide a high level of transparency as well as a stable financing supply. This relative stability has not gone un-noticed by global hedge funds and they have begun looking at Canadian prime brokers to diversify their counterparty risk accordingly.



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## Crisis, what Crisis?

Much has now been written about the events leading up to the credit crisis of 2008 and the near collapse of scores of so-called unassailable financial institutions. We are three years removed from the Lehman Brothers failure and while equity markets had, until quite recently, recouped a significant amount of their pre-crisis value, there are clearly significant headwinds threatening global recovery.

The global economic landscape is, in some respects, as troubled as it has been in some time and concerns about counterparty risk have heightened. The implications of the U.S. downgrade and the ever-looming European debt crisis, combined with pending regulatory changes have been themes that put into question the strength of many of the world's largest global investment banks.

- While a Greek default or restructuring may not necessarily cause European banks to become insolvent (outside of Greece), contagion fears and risk aversion could no doubt lead to further downgrades of some banks.
- Basel III and the Dodd/Frank legislation are expected to exert added pressure to banks' business and services. McKinsey, in their November 2010 impact study, believe Basel III will have a significant impact on the European banking sector. According to the study, by 2019 the European banking industry will need approximately \$1.1 trillion of additional Tier 1 capital, \$1.3 trillion of short-term liquidity and \$1.3 trillion of short-term funding. The capital need is roughly equivalent to almost 60% of European and U.S. Tier 1 capital outstanding.
- Similar to the Basel III initiative, Dodd/Frank legislation in the U.S. looks to force banks to reduce business activities deemed outside the scope of traditional banking norms. The long-term impact is difficult to assess, however U.S. banks are rethinking business models to accommodate the new regulations, including the winding down/spinning out of proprietary trading desks.

## Impact and Response

Hedge funds by virtue of their strategies are poised to capitalize on the ensuing market opportunities. However these same developments have caused prudent fund managers to refine their counter-party risk approach.

Five key trends have emerged to help shape industry thinking:

1. Investors are demanding more transparency into a hedge fund's infrastructure, counterparty relationships, portfolio structures and risk management.
2. Hedge funds must have a greater legal understanding of asset segregation and re-hypothecation rules, and how they apply to their accounts.
3. The multiple-prime broker scenario has increasingly become the standard structure for all hedge funds with a critical asset base.
4. Hedge funds need advanced operations platforms to manage these multiple counterparty relationships.
5. Larger hedge funds have turned to traditional custodians through tri-party relationships as additional methods to manage counterparty risk.
6. Vastly different macro environments, both from an economic and regulatory perspective, has increased importance of diversifying financing relationships jurisdictionally.

## Multi Primes and the Case for Jurisdictional Diversification

The multiple-prime broker arrangement offers a number of important benefits to hedge funds:

1. Counterparty risk diversification
2. Access to a larger pool of securities lending and hard to borrow securities
3. Research across firms and access to more companies
4. Multiple capital introduction sources

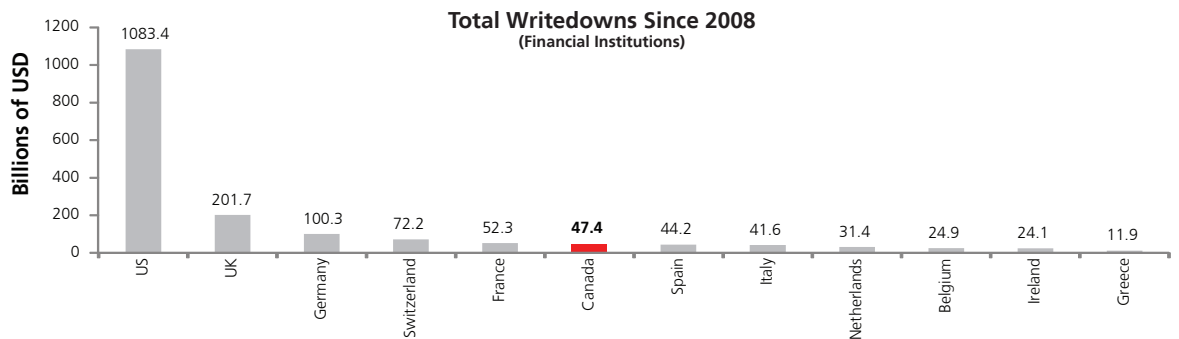
Of course simply having multiple prime brokers is not a panacea for all hedge fund counterparty ills. To complement the diversification achieved by having a multi-prime set-up, a thorough analysis of each counterparty is required. Having the right counterparties is clearly critical. Best-of-breed hedge funds are now evaluating their prime brokers, not only on service levels and pricing (the old paradigm) but on financial viability, capital ratios, quality of capital and leverage. The lessons of 2008 are all-too fresh and the strength of the prime broker and its bank parent need to be carefully considered. What has emerged is that the Canadian banking sector generates top grades in any analysis and has come through the crisis as a universally well-regarded model of success among global institutions. As seen below, Canadian Banks represent a small fraction of the more than U.S.\$ 2 trillion in global write downs since 2008.

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Total Writedowns - Americas + Europe (Billions of USD)			
Countries	To Date	Prior to 2008	WD Since 2008
U.S.	1252.7	169.3	1083.4
UK	220.9	19.2	201.7
Germany	126	25.7	100.3
Switzerland	102.5	30.3	72.2
France	67.2	14.9	52.3
<b>Canada</b>	<b>50.8</b>	<b>3.4</b>	<b>47.4</b>
Spain	46.1	1.9	44.2
Italy	41.7	0.1	41.6
Netherland	36.6	5.2	31.4
Belgium	31.2	6.3	24.9
Ireland	24.4	0.3	24.1
Greece	11.9	0	11.9

Source: Bloomberg WDCI



The Canadian Bankers Association points to four key factors for the success and stability of the system and the Canadian banks' ability to withstand the shock of the financial crises.<sup>1</sup>

1. Banking system diversified with well managed institutions:
  - a. The major investment banks are anchored by solid deposit-taking institutions
  - b. Diversification of regional risk
  - c. Lending decisions are on a case-by-case basis, extending credit to borrowers that can repay their loans
2. Canada's strong regulatory system:
  - a. Unlike the U.S., with a complex network of different regulators, Canada has two primary regulators: the Office of the Superintendent of Financial Institutions (OSFI) for regulation and the Financial Consumer Agency of Canada (FCAC) for consumer affairs
3. Strong capitalization of the national banks:
  - a. As some of the best capitalized banks in the world, Canadian banks greatly exceed the guidelines set by the Bank for International Settlements
  - b. Strategically raising equity in the marketplace when appropriate
4. Prudent Mortgage Lending:
  - a. The vast majority of mortgages are Prime
  - b. Lenders tend to hold the mortgages they create rather than securitize them
  - c. Mortgages with less than 20% down must be insured
  - d. Mortgage interest is not tax deductible
  - e. Canadian homeowners have maintained a strong ratio of equity vs. debt in their homes

<sup>1</sup> March 2009 remarks by Nancy Hughes, President & CEO of the Canadian Bankers Association to the House of Commons Standing Committee on Finance, [http://www.cba.ca/contents/files/presentations/pre\\_20090309\\_01\\_en.pdf](http://www.cba.ca/contents/files/presentations/pre_20090309_01_en.pdf)

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The advantages of jurisdictional diversity through a Canadian prime broker are multi-tiered. First, Canadian banks came through the credit crisis relatively unscathed due, once again, to prudent management and an effective regulatory policy. This has allowed some of the more internationally focused Canadian banks to expand their offerings and enhance franchises throughout North America and Europe. Secondly, three out of five of the top Canadian banks are rated AA- or better by S&P, with stable or positive outlooks. Conversely, some European and U.S. banks are facing possible downgrades due to Greek or U.S. housing exposure. A strong rating also appeals to stock lenders who, since the credit crisis, are more sensitive to the counterparties to which they lend. Thus, hedge fund managers can complement their existing securities lending access by adding a higher rated Canadian counterpart to optimize their securities lending relationships. Thirdly, the top five Canadian banks have had existing prime brokerage businesses for many years, servicing both their domestic market as well as select U.S. managers during and after the credit crisis. Canadian prime brokers have the expertise, level of service and balance sheets to support consideration as a compelling challenger to existing prime brokers in the U.S. and Europe. Finally, adding a Canadian prime broker spreads jurisdictional exposure and allows a hedge fund to move assets accordingly, based on global economic events. Having a multi-prime scenario that includes a Canadian bank appears to represent the ultimate jurisdictional flexibility, asset security and access to global services.

S&P Credit Ratings*				
Rank	Name	TODAY	Dec-07	Credit Watch
1	BNP Paribas	AA	AA+	Negative
2	Toronto-Dominion Bank	AA-	AA-	Positive
3	Royal Bank of Canada	AA-	AA-	Positive
4	<b>Bank of Nova Scotia</b>	<b>AA-</b>	<b>AA-</b>	<b>Stable</b>
5	Wells Fargo & Co	AA-	AA+	Negative
6	Bank of Montreal	A+	A+	Stable
7	US Bancorp	A+	AA	Stable
8	CIBC	A+	A+	Stable
9	Societe Generale	A+	AA-	Negative
10	Deutsche Bank	A+	AA	Stable
11	JPMorgan Chase	A+	AA-	Stable
12	UBS	A+	AA	Negative
13	Barclays Capital	A+	AA-	Negative
14	Credit Suisse Group	A	A+	Stable
15	Goldman Sachs	A	AA-	Negative
16	Bank of America	A	AA	Negative
17	Citigroup	A	AA	Negative
18	Morgan Stanley	A	AA-	Negative

\* As at September 22, 2011

## The Road Ahead

While the global economy had, until quite recently, rebounded from the tumult of late 2008, the path of recovery has shown itself to be uneven and fragile. Between the sovereign debt crisis in Europe, the introduction of new banking rules through Basel III and Dodd/Frank legislation and the continuing concern over rising debt levels in the U.S., the challenges that face hedge funds have certainly grown in number and complexity. Within the global topography of the banking industry, there are few players that have proven themselves based on their ability to successfully navigate through the financial crisis. The Canadian system has shown its resiliency through the crisis, and Canadian prime brokers are poised to grow market share from their European and U.S. counterparts.

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## Prime Brokerage Services

Scotia Capital represents the global corporate and investment banking and capital markets arm of the Scotiabank Group. With operations in some 50 countries and more than 2910 branches and offices worldwide, The Bank of Nova Scotia is Canada's most international bank, with total assets of over C\$567.7 billion (as at July 31, 2011).

Scotia Capital has long been dedicated to adding value to global hedge fund and alternative asset managers. For over two decades, we have been involved in securities lending, providing clients across Canada, the U.S., Europe and Asia with flexible and effective financing solutions. We offer a full-service equity finance platform with extensive experience in prime brokerage, securities lending, and synthetic financing solutions.

Prime brokerage is also a portal to other Scotia Capital services including:

- Capital Introduction
- Clearing, Custody and Margin Financing
- Equity Research, Sales and Execution
- Structured Derivative and Credit Solutions
- Futures Execution and Give-up Arrangements
- On-line FX Execution

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| PRIME FINANCE

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