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BASEL III AND HEDGE FUND FUNDING

In 2010, the Basel Committee on Banking Supervision (BCBS), one of the primary global financial regulatory bodies, developed the Basel III regulatory regime as a game-changing reform for the banking and financial markets sector. The main objective was to avoid a repeat of the financial crisis of 2008 by lessening systemic risk. As part of the most significant regulatory overhaul of the financial industry since the Great Depression, Basel III has redefined the means by which hedge funds may obtain financing and the rules that prime brokers must follow in order to maintain compliance with the new regulatory environment. The changes that Basel III entails will greatly impact the traditional short-term hedge fund financing model.

Reduction in Leverage

A critical relationship for the ongoing operations of hedge funds has been that of the fund to the prime broker. Investment banks have "lent" securities and cash to professional funds and individuals, thus enabling the prime broker to finance the portfolios as financial intermediary. However, Basel III liquidity and risk changes have imposed allocation limits that banks now need to factor into their daily functioning as prime brokers. Among those changes are:

- Strict Capitalization Requirements: Increasingly strict capital requirements are compelling banks to reconsider how much capital to allocate to clients and to more thoroughly investigate the clients to whom they are allocating capital.
- Bank Liquidity Risk: New liquidity metrics, Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR), are intended to increase the duration of the prime brokers' financing term as a means of reducing rollover risk.
- Leveraging: Changes in leverage ratio will reduce available balance sheet set-asides for clients, resulting in a reduction of available equity to support new and existing business.

It should also be noted that despite the intended uniformity of Basel III across national boundaries, country-specific regulators are authorized to adopt stricter metrics than those recited in Basel III, resulting in significant capitalization, liquidity and risk advantages in some markets compared to others.

Hedge Fund Adaptation

The practical effect of Basel III on the hedge fund-prime broker relationship is simply that investment banks will now — more than previously — direct resources away from lower-performing businesses in favor of bolstering their relationships with those yielding greater returns.

Hedge funds with assets that do not qualify as High Quality Liquid Assets (HQLA) will be most severely impacted by the new direction in prime broker priorities. Furthermore, beginning in January 2018, another liquidity metric — the Net Stable Funding Ratio (NSFR) — will be implemented, and although the impact date is still more than three years away, planning for the implications of this metric is already being undertaken by hedge fund managers and their prime brokers.

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