



Bringing FX Prime Brokerage to Currency Overlay

By Philip Simotas, President, FX Concepts

Philip Simotas reports on how the currency overlay industry is missing out on an important tool that can help reduce the implementation headaches that plan sponsors frequently face when implementing a currency overlay program.

Introduction:

While foreign exchange prime brokerage is becoming increasingly popular in the absolute return world, it has been largely bypassed in the currency overlay industry. Why currency overlay practitioners (plan sponsors as well as managers) have yet to embrace FX prime brokerage is somewhat of a mystery. As one of the early pioneers in currency overlay and FX prime brokerage, FX Concepts has found it to be an invaluable tool to reduce implementation hurdles and risks for clients. Specifically, prime brokerage not only reduces a client's legal costs, but also the settlement and credit risks associated with a currency overlay program.

Overcoming misconceptions and market culture

FX prime brokerage has become standard operating procedure for CTAs and leveraged currency managers. For CTAs, adopting prime brokerage is a natural, since the concept is similar to clearing their futures trading through a single FCM. But the concept of clearing interbank FX contracts through a prime broker has not gained traction in currency overlay as a result of several misconceptions:

- **Myth 1:** FX prime brokers duplicate a service that is performed already by a plan sponsor's custodian. Why do I need a FX prime broker to clear my trades if my custodian can already do that for me?
- **Myth 2:** Clearing through a single entity will increase my risk as opposed to "spreading it out" across a lot of different counterparties.

To us, this demonstrates a lack of understanding as to how the prime brokerage process works. Clearly part of the problem is that the people who are responsible for marketing prime brokerage are not necessarily fully conversant in the issues which pension funds face. We will try to bridge the gap in this article.

Currency overlay before prime brokerage

We first started employing FX prime brokerage in 1994, having developed the framework with AIG Trading Corp. Prior to adapting this new clearing facility, currency overlay implementation was very time consuming and fraught with all kinds of back office related risks.

Because currency overlay runs under a managed account framework, each of our clients come equipped with their own set of banking relations. While we tried to establish

FX lines with the same banks for all of our clients so that we could trade their accounts in a single block, this was not always possible. As we gained more and more clients, keeping track of which clients had lines with which banks became increasingly complex. So did the process of establishing fx lines at each of the banks. This was a very time consuming and expensive process. Each bank had its own documentation, which had to be reviewed by the plan sponsor or its custodian.

This also led to inefficiencies in the front office. Inefficient execution resulted as the best price provider was often not an approved counterparty. In addition, traders needed to split transactions and effect multiple trades for the same strategy.

Once we were up and running, there was the issue of settlements. Foreign exchange forward contracts that were opened with one bank were frequently closed with another dealer. On settlement day, we then had the responsibility of ensuring that the plan sponsor's custodian delivered the right currency balances to and from the various dealers with whom we had outstanding settlements. This could be across as many as 10 to 15 different banks. Any slip up, and the next few days were spent making good on deliveries and resolving any resulting interest costs. The unseen credit risk to our clients arose if their respective counterparties were unable to make a delivery. As a byproduct of our being in the currency overlay business, we were necessarily in the back office business and clients were bearing the risk..

The basics of FX prime brokerage.

In 1994, FX Concepts announced a foreign exchange trading and clearing facility with AIG International, which allowed us to greatly improve foreign exchange execution and clearing for our clients' accounts. This facility also enabled our clients to minimize the credit exposure in the foreign exchange markets by allowing them to house their currency positions at one of the foremost financial institutions in the world.

We now employ prime brokerage for all of our clients (both currency overlay and absolute return) through facilities with both AIG and Deutsche Bank. They benefit our clients in several important ways. Our clients only have to maintain one trading facility, review one set of legal documents, monitor one counterparty credit and have their custodian/back office deal with one institution. At the same time, we are able to trade on our clients' behalf with 15 to 20 major market-making institutions. Under prime brokerage, FX Concepts is able to trade on behalf of our clients with the prime broker directly and in the name of the prime broker with other institutions - our clients are thereby assured of obtaining the best execution under all market conditions, 24 hours a day.

The benefits of prime brokerage

FX prime brokerage presents a number of important benefits for our clients

- Best execution is greatly enhanced by virtue of having a large number of banking counterparties available at any time. This flexibility increases our ability to alter our

execution strategies to obtain the maximum advantage for all our clients under all market conditions.

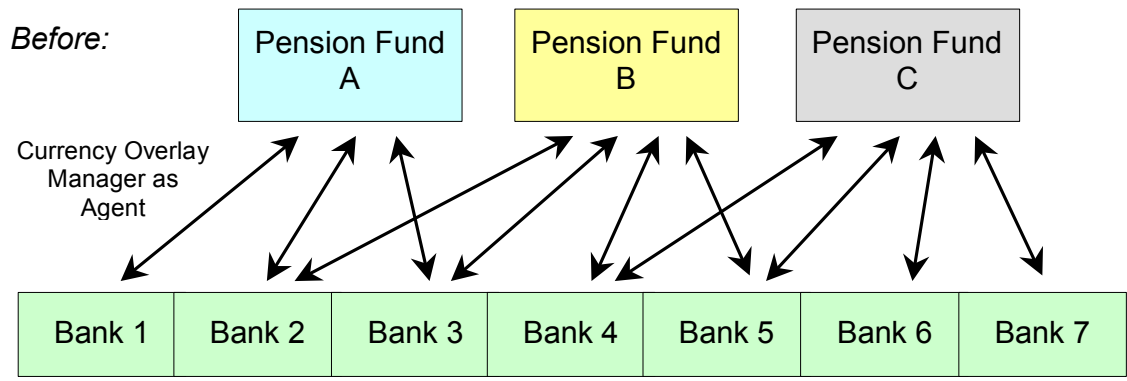
- Reduction of risk for the majority of our clients will be possible because all client positions will be with the prime broker. For those clients with multiple bank relationships, large currency settlement exposures are almost entirely eliminated since all transactions are settled with one institution on a net basis.
- Transaction processing becomes standardized and automated, leading to clear audit trails and enhanced controls.
- Legal documentation is necessary for only one account.
- It allows the manager to execute all client accounts as single bloc trades, thereby ensuring identical performance across all accounts.
- Prime brokerage provides the client an independent audit. This is very important as not all custodians are familiar with fx contracts and often do the related accounting only once a month.

Furthermore, it allows the currency overlay manager to outsource the back office element of his operation and to focus on its core competence, which is managing currency risk. Ultimately, prime brokerage has allowed us to manage a larger asset base with the same number of people as the efficiency of our operation has improved.

Settlement risk reduction – the details

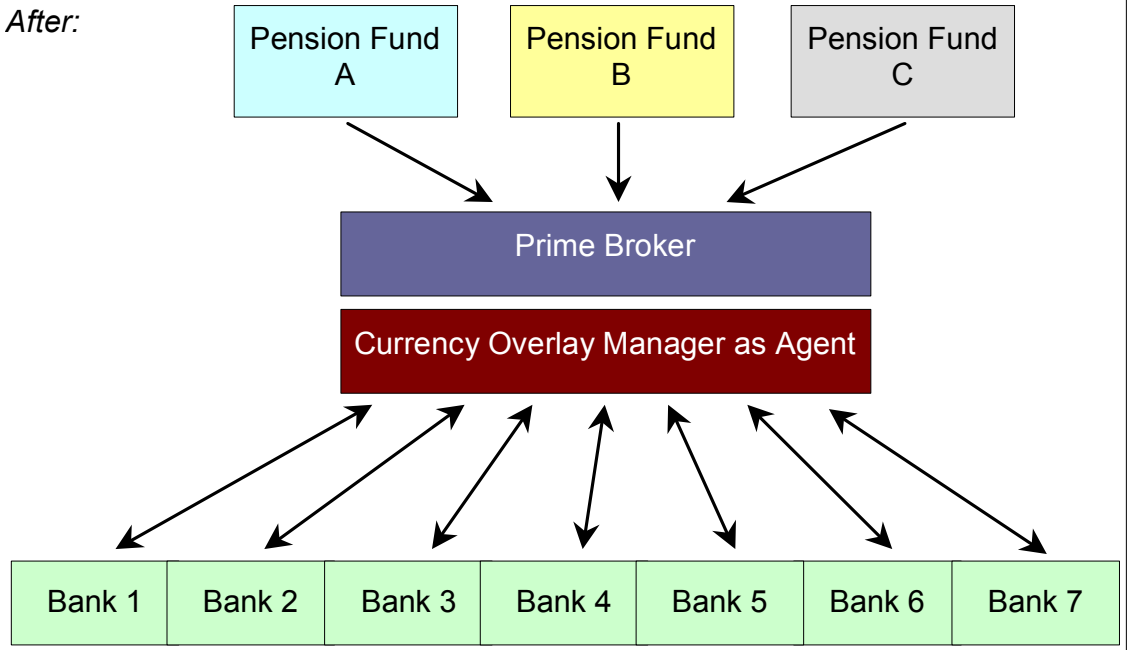
Prime brokerage greatly reduces settlement risk for those currency overlay clients who currently maintain credit lines for foreign exchange trading at more than one financial institution. When the overlay manager liquidates a client position, which was initiated with a different bank, the client is responsible for the delivery and settlement of currency balances on value day for both contracts.

Figure 1: Transaction Flow Before FX Prime Brokerage



Client	Approved Banks
Pension Fund A	Bank 1, Bank 2, Bank 3
Pension Fund B	Bank 2, Bank 3, Bank 4, Bank 5
Pension Fund C	Bank 4, Bank 5, Bank 6, Bank 7

Figure 2: Transaction Flow After FX Prime Brokerage



For example, if FX Concepts, on behalf of a customer, buys 20 million EUR from one bank and later closes that position by selling 20 million EUR with a different bank, the customer bears the full responsibility of the EUR and USD payments from one bank to another. By dealing through a prime brokerage relationship, this responsibility and the accompanying risk is eliminated. Designated banks under the prime brokerage facility will now only recognize transactions with the prime broker. The customer is relieved of any obligation should one bank make an error in delivery or fail completely. Our clients' only risk is for the net position with the prime broker, as all trades are in and out with the clearer. In the above example, the only exposure would be the net USD amount from the two trades. (The EUR balances net to zero.)

This facility allows our customers to maintain all the benefits of trading with multiple counterparties, namely liquidity and flexibility of execution, while eliminating a potentially enormous exposure in the form of settlement risk. The resulting dollar settlements to or from the prime broker will be small relative to the bulk amounts traded.

Conclusion

As plan sponsors frequently struggle with the complexities surrounding currency overlay, prime brokerage can help to streamline many of the implementation issues. The benefits to clients (pension funds, institutional funds, etc.) employing currency overlay managers are numerous and should not be ignored. The reduction in settlement risks, clearing risks, credit risks, and legal costs coupled with the enhancement in execution and audit procedures are benefits that extend above and beyond what might be provided by custodians. Currency overlay managers need to do a better job of communicating the potential benefits from a prime brokerage arrangement to their clients as well. Finally, helping to remove some of the hurdles in the enacting a currency overlay and improving manager efficiency will help to grow the overlay market as well.