TAKING OUT THE CASH

Amid the regulatory crackdown on bank balance sheets, cash has turned into trash. *HFMWeek* explores what hedge funds need to consider and what options they have for parking their excess balances

BY JASMIN LEITNER

While cash was once king, it is now considered "trash", managers tell *HFMWeek*. The view is echoed by banks, and for good reason.

Regulations such as Basel III, and the equivalent US G-Sib rules, mean banks have to adhere to stricter liquidity coverage and leverage ratios, affecting their treatment of cash.

Deposits, which are considered reliable and likely to remain during a crisis, are classified as 'operating' and can be used by banks to fund their products and loans. Others, such as hedge funds' excess cash, are classified as 'short-term' and 'non-operating', because they are subject to swift withdrawals in times of stress, requiring banks to hold additional capital to cover the perceived flight risk.

Those deposits count as balance sheet liabilities, so banks have to create an asset to match them against; this counts against their leverage ratios, Mike Manna, head of fixed income financing at Barclays, explains.

"The banks' leverage increases and negatively affects its leverage ratio, not because it uses its balance sheet to facilitate leverage for a hedge fund, but because they are taking a deposit."

At its annual investor day this year, JP Morgan announced it was aiming to clear non-operational deposits worth $100bn from its balance sheet by year-end, with particularly large cash balances facing charges to cover the costs the investment bank faces in holding them.

Reports indicate that Citi, HSBC, Deutsche Bank and Baml have followed suit in advising clients who only use their custody facilities to close those accounts, while others, such as Goldman Sachs, won't take on new prime clients unless they agree to move their excess cash off balance sheet, one manager told *HFMWeek*. Goldman Sachs declined to comment.

TREASURIES, REPO AND MMFS

Options for where to park these balances, and in what format, are limited.

"It depends on the strategy, the background of the firm and what's in their prospectus, as well as their sensitivity to yield and risk," explains the head of EMEA prime finance at one bank.

One option is to buy high-quality securities, such as US treasuries or German bunds, something which one Swiss-based CTA plans to do.

"We tend to sweep our unencumbered cash from our FCM to our custodian, but going forward we'll roll it into T-Bills," explains the COO at the $100m firm.

"We're conservative and not looking to generate returns on the cash element. Investors are buying our strategy for the commodities exposure not for interest rates, and we think this is a more prudent credit approach."

For banks, having a physical security in custody is not balance sheet-intensive. "If you buy bonds, it's a fully funded asset, and in the UK, if you had a prime or custody account and it's not re-hypothecated it comes under CASS rules so it's a client asset and off balance sheet for us," the EMEA prime finance head explains.

Barclays' Manna adds that any hedge fund well-versed in buying securities (as opposed to derivatives) should be relatively comfortable buying treasuries. "It will fit into their [existing] risk framework and the process is something they'll be familiar with."

Other COOs stress however that without in-house expertise going directly to the capital markets for a solution is risky. "Unless you have that specialism, who are you to choose?" says one COO from a stat arb-focused firm.

For those that don't want to purchase securities outright, making use of a bank's repo capabilities is another possibility.

"We've seen hedge funds using the repo market to borrow high-quality short-dated collateral," says Barclays' Manna, adding that this makes sense for fixed income and macro hedge funds familiar with repo.

Paul Calderone, COO at treasury management solutions provider HazelTree, says repo can be resource-intensive to facilitate as managers need to monitor their collateral schedules more frequently.

Calderone notes some managers opt for regional bank certificate of deposits which, while small, are FDIC-insured. Money market funds (MMFs) are another, more popular, contender.

"That's the most likely outlet for a lot of cash," he says, explaining that MMF providers are particularly keen to attract hedge fund assets.

ENSO Financial Management founder and partner Michael Gentile agrees. "There isn't a tonne of money in MMFs at the moment. I would say around the mid-single digit billions – but there's a lot more interest, so I would imagine that over the next two quarters that could double."

"It's certainly an area we hope to grow from an investor base perspective," says Paul Wilson, head of sales – liquidity solutions at Aberdeen Asset Management.

"[MMFs] are popular with hedge funds because they provide same-day access to a very workable cut-off time, and they have a credit team doing counter-party due diligence within the product."

He adds that the average seven-day yield of the Institutional Money Market Fund Association universe is currently 22bps for USD, 55bps for Sterling and -1bps for Euro-denominated products.

The COO at one $1bn-plus Boston-based manager says they will comply with the request from their primes, Goldman Sachs and Morgan Stanley, to sweep excess balances into bank-owned MMFs but adds they have stipulated the right to withdraw at any time.

"The only real risk with MMFs is if the buck were to break [as it did in 08/09]," he says. "If we feel there's another event like that on the horizon we would pull our cash."

Using a bank product means they can set up an automatic sweep, which is easier than having to move it manually, as would be necessary with an independent provider, he adds.

"If you don't do it automatically it's challenging - you have to monitor and manage your cash balances intra-day, and would have to effect lots of transfers, depending on trading frequency."

MMFs carry different ratings, with some investing only in government-issued securities, while prime funds focus on the securities of financial institutions and corporates.

"The difference in return is a couple of basis points, so [investing in a prime MMF] is not worth the risk," the COO says, explaining they prefer MMFs focused on government paper.

CUSTODY

Whatever managers decide to do with their cash, market participants stress the decision needs to be justifiable to investors.

"No one wants to lose money in cash. Your investors will probably tolerate you losing a bit in your portfolio, but they will definitely be upset if you lose money in treasury," ENSO's Gentile says.

And indeed, it can be problematic if cash management becomes an investment issue, Graham Rodford, COO at UK-based Omni Partners, says.

"You're in danger of distracting the front office from the day-to-day running of the book, and you have to ask if it's really worth it, particularly as you need to explain it to your investors," he says. "And if you're earning [higher] returns, there will be risk there somewhere which you really need to understand."

For Omni, keeping its cash in custody is preferable to other options, says Rodford. "Our macro strategy has very low margin requirements given the instruments it trades. It maintains healthy excess cash balances and a couple of years ago we decided to put that [excess] to work more effectively."

"We looked at the various types of money market funds and bank products on offer. Some were very complex and still seemed to result in relatively low yields for the amount of work, operationally, that had to go into understanding them," he says.

"We found there were still places happy to take cash at relatively attractive rates compared to what you'd get from leaving it at your prime," he says, explaining they use two cash custodians, one on an overnight basis and the other in a longer-term arrangement.

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"Some banks have already dealt with the new capital ratio requirements," explains the US-based head of alternative solutions at one top-20 custody bank.

"We're not as balance sheet-constrained and provide straight cash solutions to our clients," he says, adding that managers facing the closure of a custody account with their prime should look at what their other bank relationships can offer.

INVESTOR EDUCATION AND TREASURY ROLES

Two themes emerge from the cash management question; the importance of investor education and the growth of a dedicated treasury function within hedge funds.

"So far the discussion is between hedge funds and banks, but end-investors will need to think about how they want managers to deal with their cash constraints," the EMEA head of sales says.

The head of alternatives at the US custodian agrees. "Investors need to be educated as to why these changes are happening and how it impacts their managers' investment profiles when a portion of the assets goes from being risk-free to carrying an element of risk."

Larger firms are well-known for having dedicated treasury functions, but smaller firms are also starting to add head count to this role, explains ENSO's Gentile.

"Hedge fund managers need to better manage their internal cash, distribution of balances and blends of business across prime brokers, and we're definitely seeing lots of seasoned sell-side professionals going to managers of all sizes," he says.

One $200m start-up plans to hire a head of portfolio finance as a member of the founding team, making the role junior but providing firm equity. "That shows the value being placed on the role in today's environment," Gentile adds.

And if you have a dedicated treasurer, the question of cash management becomes "a different ball game," the EMEA head of sales says. "You start to see more innovative solutions like tri-party or agency lending and evergreen repo." ■