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Basel III E: Synthetic Financing by Prime Brokers

Yale Program on Financial Stability Case Study 2014-1E-V1

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Yale School of Management; National Bureau of Economic Research (NBER); Yale University - Yale Program on Financial Stability

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Abstract

Hedge funds rely on “prime brokerage” units within banks to provide leverage. With the enhanced capital requirements and new liquidity standards introduced by Basel III driving up the cost to banks of engaging in such financing, prime brokers have begun to offer an alternative means of providing hedge fund clients with leveraged exposure to securities. Known as synthetic financing, this alternative requires the prime broker enter into derivatives contracts with the clients. Under the Basel III framework, the ability of banks to hedge and net such derivative positions results in capital and liquidity costs for synthetic financing that are lower than those for traditional securities financing. This case considers whether synthetic financing should be treated differently than traditional securities financing for capital and liquidity requirement purposes, as well as considering the risks associated with the shift toward synthetic financing.

Keywords: Systemic Risk, Financial Crises, Financial Regulation**JEL Classification:** G01, G28[Suggested Citation](#) >[Show Contact Information](#) >

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