SECURITIES-BASED LENDING:

A GROWING TREND

MAY 2018

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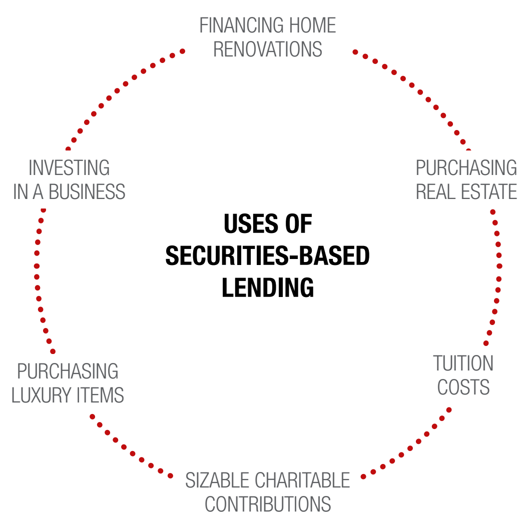
Securities-based lending (SBL) products have emerged as an increasingly popular choice for high-net-worth and ultra-high-net-worth clients with short-term liquidity needs. Among financial firms, there is a growing appetite to invest in this area. Firms not already offering SBL risk losing brokerage customers. Those who have the product are looking to automate processes, particularly loan origination, as competition is forcing them to reduce a 3-4-week process to 1-2 days. Firms with mature platforms are focusing on product features, optimized digital access for internal and external advisors, and extending the product to more customer segments.

This paper explores the mechanics of SBL, including the benefits and risks for both the borrower and the lender, and the current product market. We also look at how firms are approaching this product and the barriers they encounter.



UNDERSTANDING A SECURITIES-BASED LOAN

Securities-based lending enables a client to borrow against the value of his or her existing, non-retirement brokerage account for any purpose except purchasing more securities or paying margin debt. To secure an SBL, clients must seek financial advice to assess their options, including whether their current financial institution offers this product. During the loan origination process, the client's securities are assessed for eligibility. Once restricted or ineligible assets are removed from the estimate, eligible assets are assigned varying advance rates based on their perceived risk and size of the loan. For example, cash accounts are allotted an advance rate as high as 95%; whereas a fairly risky 3x leveraged ETF may support only a 20% advance. Most firms require a minimum loan amount of $100,000, to avoid triggering regulatory requirements of the Truth in Lending Act (TILA, Reg. Z), but can go up to $25 million. The maximum SBL loan amount is determined by the client's pledged portfolio size.

In addition to screening assets, firms must screen potential SBL borrowers for suitability, credit risk, reputation risk, and regulatory compliance. Depending on their risk appetite, financial firms may skip credit checks and income verification, relying instead on the value of the collateral. With robust automation and systematic processing in place, these checks can be run behind the scenes while the financial advisor (FA) and client continue with the application process, thus reducing the time to book a loan.

EXAMPLES OF ASSETS ELIGIBLE FOR SBL

- CASH
- LISTED SHARES
- GOVERNMENT BONDS
- REAL ESTATE INVESTMENT TRUSTS
- PREFERRED SHARES
- LOCAL CASH INVESTMENTS

BENEFITS
AND RISKS

FOR CLIENTS

Choosing an SBL as a financing vehicle allows for the client's existing securities to remain invested. It also enables clients to take advantage of any market upswings and to avoid potential tax consequences from selling assets (e.g. capital gains tax). Clients can continue to reinvest dividends from their pledged collateral, keeping any returns. In many cases, they can continue trading in the pledged accounts, as long as the collateral is sufficient to support the loan amount. Clients can use the proceeds of these loans at their discretion, such as paying taxes or purchasing real estate. The sole restriction is that these proceeds cannot be used to purchase additional securities or to repay a margin loan.

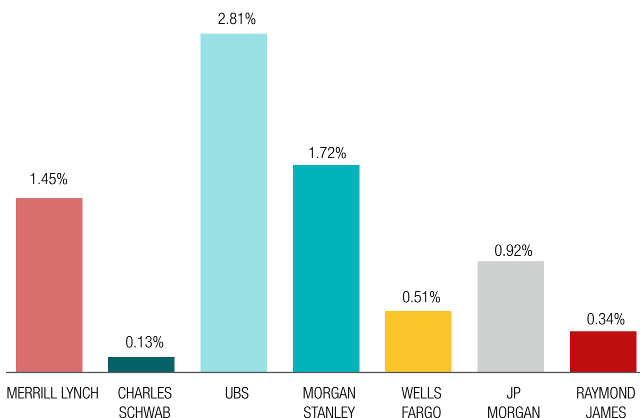
Clients must also understand the inherent risks of the product. One such risk is the devaluation of the loan's underlying assets. Pledging securities as collateral means that assets may be sold by the financial institution to cover the outstanding loan, should the value of the securities drop below a pre-established threshold.

FOR FINANCIAL FIRMS

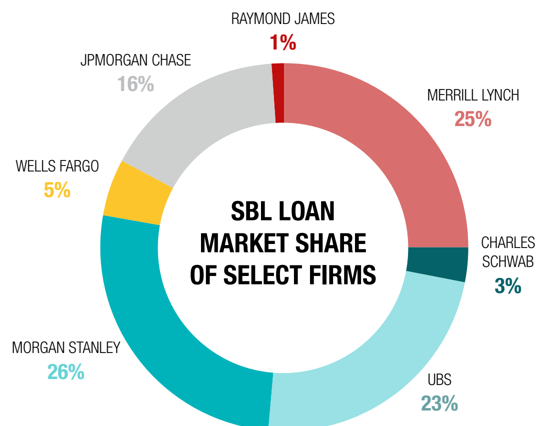
SBL is an attractive product for financial institutions, as clients' wealth management assets become 'stickier'. Clients are not only less likely to transfer-out their portfolio if it is pledged to an outstanding loan with the same firm, but they also tend to transfer-in assets from other firms to obtain a larger loan amount. Furthermore, SBL adds another income stream from existing assets such as interest income, in addition to existing broker commissions or asset-based management fees. And, with the assets pledged, the in-house collateral creates an extremely risk-adverse loan for banks.

However, for firms, SBLs also mean increased regulatory scrutiny. In addition, if a client's portfolio requires liquidation, partial or full, to meet a margin call, it could create a negative client experience and heighten reputational risk. Another aspect that firms making significant investment in automation must consider is that the product does not usually charge upfront costs or unused credit line fees. As a result, if clients open SBL accounts but do not draw from their line of credit, institutions are not able to recoup their investment costs as quickly as anticipated.

SBL PORTION OF AUM AT SELECT FIRMS



Source: Companies' 2017 annual reports, Capco analysis

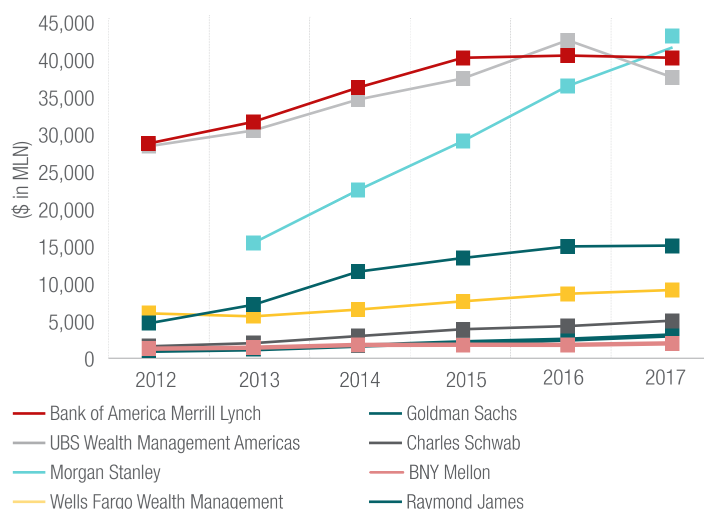


Source: Companies' 2017 annual reports, Capco analysis

PRODUCT DEMAND

The low risk nature of SBL has naturally led to a growing demand in the lending market. The freedom of funds, coupled with the potential ease of opening an account and receiving funds, make SBL an attractive proposition for potential customers. For financial services companies, from small brokerage firms to large Tier 1 banks, SBL brings a low-risk leveraging of brokerage assets, making the product enticing for all parties.

SBL GROWTH AT SELECT FIRMS, 2012-2017



Source: Companies' 2017 annual reports, Capco analysis

We have witnessed the growing appetite of financial institutions to either launch an SBL product or enhance their existing platform and product offerings. As financial institutions seek to automate their account opening processes and improve their time to book a loan, customers will be increasingly drawn to SBL as an alternative to mortgages, home equity lines of credit and other methods of financing. Moreover, as banks and brokerage firms are entering the securities-based lending market in increasing numbers, they are dedicating more time and resources to marketing and enhancing the product's exposure to clients – HNW/UHNW and mass affluent, FAs and Registered Investment Advisors (RIAs).

Overall, it is difficult to accurately gauge the full SBL market, since neither the Federal Reserve nor FINRA tracks SBL figures separately from other consumer unsecured debt. However, firms' desire to expand the product's availability to a wider constituency of clients and the range of banks interested in offering the product demonstrate SBL's potentially lucrative opportunity.

HOW FINANCIAL FIRMS ARE APPROACHING SBL

There is a wide spectrum of SBL capabilities in today's financial services industry. Firms that are offering the product simply to appease and retain existing HNW clients have under-developed platforms and book loans on an ad hoc basis. These institutions' processes and workflows, especially in the origination phase, are often manual and time consuming, with loan applications taking on average over a month to complete. These firms are less concerned with the product itself and focus on standardizing their procedures to make SBL processing less painful for their clients and internal operations teams.

Firms with more mature platforms have significantly different priorities for enhancing their SBL offerings. They have already automated and standardized procedures and are actively streamlining processes and improving client satisfaction. Our experience suggests that these institutions are investing millions to enhance their SBL product offerings, whether through the implementation of straight-through loan application processing or overall digitization for improved efficiency and user experience. Such enhancements significantly speed up application processing time and improve digital journeys through integration with RIA/FA workstations, user-friendly navigation, online assistance, application status alerts and mobile/tablet access.

As software and operational processes continue to standardize, lending capabilities and functionalities are becoming more readily accepted and relatively inexpensive to implement. In the long term, the goal is to move to full client self-service where clients or advisors can apply online and receive a loan decision almost instantaneously, similar to Quicken Loan's Rocket Mortgage business model.

TYPICAL PROBLEMS FIRMS ENCOUNTER

As the industry evolves, complexities and hurdles with product launches and enhancements are inescapable. Some of the largest obstacles firms are facing with securities-based lending include:

- **Highly manual loan origination processes**
  - Due to the manual labor-intensive nature of most platforms, it can take weeks, if not months, to process applications. This limits the SBL offering to high-net-worth clients.
  - Delays in processing can be aggravated by common issues like missing information, excessive lead times to transfer in external assets, mail courier delays and convoluted underwriting procedures.
- **Complex legal and organizational structures**
  - Both banks and brokerages are necessary to establish an SBL product - the bank supplies and services the loan, the brokerage holds the pledged assets. Even if the bank and brokerage are under the same umbrella company, they are legally separate entities, which leads to additional legal hurdles.
  - When a brokerage brings in a third-party bank to issue and maintain the loan, there are even more complexities with technical, legal and cultural integrations.
- **Heavily regulated environment**
  - SBL is regulated by both the Federal Reserve and FINRA. There are multiple regulations that firms considering the SBL market entry must become compliant with.
  - One example is Regulation Z, the Truth in Lending Act, which requires full disclosure about the product's terms and costs. To minimize complications from this regulation and limit its disclosure requirements, many firms have a minimum loan amount of $100,000, which guarantees exemption from compliance with Regulation Z.
  - FINRA's Suitability Obligations is another sensitive regulation. It requires an FA to satisfy his or her fiduciary responsibility to the client regarding product suitability. At the same time, FAs must comply with the requirements of Regulation B (Equal Credit Opportunity Act) to accept an application from any interested borrower.
- **Customer expectations of technology and services**
  - Many HNW and UHNW clients expect a 'white glove service', which often includes traditional face-to-face relationships, particularly attractive to older generations.
  - With the growing dominance of Generation X and Millennials in the wealth management domain, expectations will shift towards fully digitized lending solutions and self-service functionality.

CONCLUSION

Today's relatively low interest rates and the low risk nature of SBL continue to feed the growing demand for the product. As competition increases, superior customer experience is becoming a vital differentiator for financial services firms. Those with mature SBL platforms will be able to focus on enhancing their SBL products, optimizing the digital experience for RIAs, FAs and their clients, and expanding SBL reach beyond HNW and UHNW to the mass affluent segment.

At Capco, we understand the SBL product and the components required for an industry-leading solution, including client/FA experience, origination, underwriting, operations, compliance, and technology. We have experience with designing and implementing SBL platforms, from a roadmap that uniquely matches a firm's future state, to integration with new or existing platforms. Our focus on financial services allows us to build specialized competencies in areas such as SBL and provide independent advice and solutions to our clients.

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ABOUT CAPCO

Capco is a global technology and management consultancy dedicated to the financial services industry. Our professionals combine innovative thinking with unrivalled industry knowledge to offer our clients consulting expertise, complex technology and package integration, transformation delivery, and managed services, to move their organizations forward. Through our collaborative and efficient approach, we help our clients successfully innovate, increase revenue, manage risk and regulatory change, reduce costs, and enhance controls. We specialize primarily in banking, capital markets, wealth and investment management, and finance, risk & compliance. We also have an energy consulting practice. We serve our clients from offices in leading financial centers across the Americas, Europe, and Asia Pacific.

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