STRUCTURED LENDING

INNOVATION OPPORTUNITIES IN WEALTH MANAGEMENT

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Lending is how modern banking began. In the middle-ages, financiers and borrowers in Northern Italy gathered on benches to agree loans, hence the terms banking (from banco - the Italian for bench) and Lombard lending (from Lombardia – the name of the region). Centuries later, the traditional business of lending is enjoying a renaissance. In this paper, we look at structured lending, its benefits, risks and innovation opportunities, including peer to peer.

NOT EVERY BANK WILL LEND AGAINST A PICASSO

Structured lending is the practice of lending substantial sums to high-net-worth clients, tailoring the conditions of the loan to the customer's specific needs and using non-standard assets as collateral to secure the borrowing. For example, an entrepreneur holding large amounts of stock in a company may be borrowing USD 10 million - in several tranches - to finance a new venture, secured by existing holdings in a single-equity position.

Structured lending, also known as tailored lending, allows banks to offer a distinctive and valuable service to high-net-worth clients. Only some wealth managers demonstrate the flexibility required by clients in this space. Not all have the necessary capabilities to value and monitor exotic collateral, not all have the risk appetite for certain types of collateral and not all have the balance sheet capacity and capital ratio to execute a structured lending transaction.

For clients, structured lending offers an opportunity to make fuller use of their assets and to follow a wide variety of sophisticated investment strategies. Additionally, funds may be used to finance purchases of non-financial assets (i.e. not in bank's custody), such as companies, property, aviation or marine assets. The availability of lending is not an end in itself. Rather, it enables new transactions to be concluded, which are potentially lucrative for both the client and the bank.

STRUCTURED LENDING IN A NUTSHELL

- Large, tailored loans with non-standard features, e.g. tranches, interest structures or maturities
- Clients are HNW or UHNW individuals or corporations
- Loans start at USD 5million and range up to hundreds of millions, average loan USD 15 million
- Loans are collateralized by assets other than residential property or diversified stock portfolios
- Assets used as collateral are often illiquid, concentrated, exotic or complex, i.e. hard to value or sell
- In case of a default, the bank claims the collateral and may have recourse to clients' other assets or cash-flows to make good any shortfall
- Structures may be cross-border, with borrowing onshore and assets held offshore

NEW SOURCES OF REVENUE AND GROWTH FOR WEALTH MANAGERS

Structured lending is a strong revenue generator. Margins are high, often in excess of 200bps (compared to less than 100bps for mortgages and classic Lombard lending secured by diversified portfolios). On the most exotic collateral, margins exceed 700 bps. Combined with the large loan sizes, this can quickly add up to a significant interest income stream. On top come the additional revenues from the use of funds – transaction fees, commissions and other income. Reinvestment of loan proceeds typically yields 80-100 bps of gross revenues to a wealth manager.

Clients with complex loans and niche collateral are 'stickier' and less likely to leave. Clients appreciate the added-value of a structured loan and are less inclined to transfer-out their portfolio if it is pledged to guarantee a loan. They can put their assets to work rather than simply having them sit in safe-keeping.

Lending is a powerful differentiator and driver of assets under management (AUM). As mentioned earlier, not all competitor institutions offer lending on non-standard collateral, particularly if it is exotic, or offer highly customized structures and comparable terms such as lending value. Existing clients may be persuaded to bring additional assets to the bank if the bank is prepared to lend against them, while new clients may be attracted by differentiated lending capabilities.

Several of the larger wealth managers, including UBS, Credit Suisse, Morgan Stanley and Bank of America, have reported strong growth in loans, including those secured with non-traditional collateral. For example, UBS's 2018 annual results show a 29 percent year-on-year rise in loans secured by guarantees and other collateral.[1] According to Barron's, Bank of America's finance chief said that structured lending helped drive third-quarter results in the company's wealth unit in 2017.[2]

This growth is coming in part from an ever-wider range of assets being accepted as collateral. Recently, assets such as private equity funds, hedge funds or unlisted equity positions have become accepted on a routine basis. This reflects banks' increasing sophistication to manage these assets with a corresponding balance of risk appetite and revenue potential.

Structured lending offers an opportunity to satisfy client needs, generate significant revenues and grow AUM with relatively well-understood risks. Big institutions can leverage their in-house specialist capabilities and balance sheets to absorb the risks, whilst boutiques can competitively take risks in their niche capabilities or use partners for expertise and risk transfer. We will cover risks in more detail later in the paper.

There is additional revenue potential for larger firms with advanced capabilities to value and monitor collateral (e.g. through an in-house investment bank or specialist function). These firms may take on the lead-arranger role in syndicated financing models, where the size of the loan exceeds the risk appetite or balance sheet capacity of the lead institution.

TYPICAL PURPOSES OF A STRUCTURED LENDING LOAN

Proceeds invested into financial assets are held in safekeeping by the bank, contributing to the overall collateralization of the loan.

- Reinvestment, leveraging an existing portfolio, growing a portfolio without selling assets
- Enhancing risk diversification by reinvesting, hedging a strategic holding, financing liquidity needs

Assets are not in the bank's safekeeping, and unless specific pledges are made, beyond recourse in case of a default.

- Financing non-financial asset purchases such as companies, real estate, marine or aviation assets
- Financing M&A activity or investment into a business or segregating personal wealth from that of the business

REFERENCES

[1] https://www.ubs.com/global/en/about_ubs/investor_relations.html

[2] https://www.barrons.com/articles/lending-to-investors-is-powering-wirehouses-1508348146

WHAT'S THE CATCH?

With new sources of revenue and increased AUM come costs, efforts and risks which must be understood and considered carefully before starting or growing this business.

As a bespoke and non-standard product, tailored lending requires sophisticated capabilities to structure, originate and manage the loan through the entire lifecycle. In addition, relationship managers must understand the product very well to effectively identify opportunities in client portfolios and to promote and sell these products.

The ability to value collateral is crucial for engaging in this business. Assessing the value, volatility and liquidity of collateral is vital in deciding how much to lend against it. Too conservative an approach - as is often the case - will result in uncompetitive lending values and pricing and potentially lose business. Banks without an in-house evaluation capability can seek advice or services from specialised third-parties (e.g. real estate boutiques or investment banks).

Banks must have the appetite to take on the risk of the collateral. Both the type of collateral (e.g. real estate, private equity, illiquid or volatile stock) and the size of exposure must be within the bank's risk framework and appetite. Loans of tens or hundreds of millions may have significant effect on the exposure and balance sheet capacity of smaller, boutique players. As with evaluating collateral, third-parties can be used to syndicate exposures or to transfer risk to institutions better placed to manage it.

A holistic assessment of the client portfolio is necessary for the full economic benefit of structured lending. Lending is an enabler which allows to execute additional transactions and generate ancillary revenues. It may be beneficial to lend at low profit, if the loan will let a client enter other, more profitable transactions such as reinvestment, hedge, M&A activity or IPO. A disconnected view of departmental revenues or lack of an effective approval body can become an obstacle to providing the right overall service to the customer.

Finally, these transactions require specialist input from many areas such as legal, risk, investment bank and wealth managers. This should also include non-standard operations and risk management during the deal lifetime. To facilitate, banks need to have established and effective collaboration between departments.

TYPES OF COLLATERAL ACCEPTED IN STRUCTURED LENDING (NON-EXHAUSTIVE)

COMMONLY ACCEPTED

- Single-stock positions
- Marketable securities
- Fixed income-backed loans
- Hedge fund positions
- Bridge loans
- Syndicated loans

OCCASIONALLY ACCEPTED
(margins can be over 600 bps, LTV 10-50%)

- Life insurance
- Cash flow based lending
- Unlisted equity
- Equity derivatives and interest rate hedging
- Commercial real estate (typically as part of a syndicate with other banks)
- Precious metals

ACCEPTED BY SOME INSTITUTIONS / WILL BE ACCEPTED IN NEAR FUTURE

- Pre-IPO and take-private financing
- Leveraged buyouts, M&A related financing
- Real estate, including premium recreational or investment trusts
- Unsecured credits
- Fine art
- Aircraft and marine assets
- Intellectual property (e.g. royalties on a song or film)
- Digital assets, cryptocurrencies

HOW IT WORKS

IDENTIFY	ORIGINATE	STRUCTURE	PRE-APPROVE	NEGOTIATE & APPROVE	EXECUTE	MONITOR

IDENTIFY

Relationship managers seek opportunities by identifying suitable collateral in clients' portfolios as well as assets held externally and matching these with needs for liquidity and opportunities for investment.

Key to success is a comprehensive understanding of the client's overall position, financing needs and investment goals in order to identify suitable collateral and suggest best uses for funds, and to then convey this to the client with a compelling narrative. Furthermore, relationship managers need to be well trained on the product, firstly to know where and how to look for possible collateral, and secondly to be able to explain the benefits and risks of the structured loan.

ORIGINATE

Lending specialists are involved to shape the transaction and make preliminary assessment of suitability and feasibility. Alternative terms or structures may be considered at this stage. Lending values are assigned to assets, depending on perceived volatility, liquidity and complexity.

Key to success is the availability of dedicated product experts with informed views of which structures may or may not be effective.

STRUCTURE

Market and product specialists perform valuation and risk analysis on the collateral. The specialists could be the in-house investment bank of a large institution or a third-party investment bank or assessor in the case of specialist assets (e.g. commercial real estate or fine art). Counsel is frequently necessary to provide a solid legal underpinning with pledges on the assets and recourse to the beneficial owner in case of shortfall. Robust and often bespoke legal agreements for covenants and pledges may be put in place at this stage.

Key to success is a rigorous process and a checklist to ensure all relevant aspects are considered. Access to an investment bank with expertise and existing books and positions in specific stocks is an advantage when considering single-stock or unlisted equity collateral.

PRE-APPROVE

This step is a preliminary approval in principle.

Key to success is a holistic view of the transaction and the impact on the bank's revenue, risks and risk-weighted assets/balance sheet. A pragmatic approach is useful to encourage transaction flow, but a rigorous identification of red-flags is essential, to avoid wasting effort on unsuitable cases and ultimately prevent losses.

NEGOTIATE AND APPROVE

Final structuring details, terms and pricing are agreed with the client and any third-party providers. The transaction is approved by a risk/lending committee.

Key to success is a quick turnaround and the existence of the pre-approval step. Comprehensive research on the collateral and necessary legal structures together with a standardized and widely-understood approval process will facilitate the thorough understanding of risks (and opportunities) by the risk committee and avoid delays in the process.

EXECUTE

The financing, investment and hedging transactions are all executed, possibly requiring precise synchronization. Multi-part transactions should be captured in such a way as to allow the holistic analysis and reporting of the entire structure. Where risks are transferred to third-parties or multiple jurisdictions are involved, banks will need to manage the additional complexity.

Keys to success include flexible deal processing systems able to capture and evaluate complex, multi-leg transactions and capabilities to manage unusual asset classes.

MONITOR

The final stage involves valuation and monitoring of the collateral, resulting positions and risks, and reporting to the client. This also includes computing and collecting margin calls, and any eventual escalations and liquidations if necessary.

Keys to success include risk systems able to provide effective valuations, particularly in times of stress. A solid process and an approach to liquidation prepared ahead of time (in normal conditions) are invaluable if positions must be sold under stress or time pressure. Rigorous legal documentation is essential to underpin recourse and recovery of value from beneficial owners.

WHAT ARE THE RISKS AND HOW TO MITIGATE THEM

CREDIT RISK

Credit risk on the borrower is limited in structured lending, thanks to the pledge of assets as collateral. Nevertheless, some residual credit exposure remains in the case of collateral shortfall (e.g. sudden sharp fall in the assets value).

To mitigate credit risk, banks need thorough understanding of the client and the purpose / business case of the loan, together with recourse to income streams or pledges of the assets. If the loan is for reinvestment within the bank, then recourse to other wealth and liquidity positions of the borrower can compensate shortfall.

MARKET RISK

Fluctuations in the value of collateral and its ability to be converted into cash are the largest risks in structured lending. These risks are exacerbated due to infrequent valuations of illiquid, hard-to-value and sell assets. In addition, market liquidity is a significant factor. It may take months or years to dispose of collateral such as unlisted or private equity, companies, physical assets or digital/crypto assets.

Mitigating market risk requires effective and robust collateral management. This should ensure diversification of collateral (types) across the portfolio and appropriate limits / exposures, in line with the firm's risk appetite. To achieve this from the operational standpoint, firms need to revalue collateral frequently and rigorously enforce margin calls/top-ups.

Large groups with investment banks or specialized boutiques have the advantage in valuing collateral and managing it together with existing portfolio positions. In cases where the capability to measure the risk does not exist in-house, third-parties may provide valuations. However, it may be a challenge to achieve this quickly, especially in turbulent market conditions. Finally, risks that are not within a firm's appetite may be completely or partially transferred to third-parties to manage. Some lenders are actively seeking to sell parts of their larger existing loans to other banks in order to adapt their exposures to reduced risk appetite.

OPERATIONAL RISK

The complex, bespoke nature of structured lending transactions and the diverse assets used as collateral lead to higher operational risks. Processes are often manual, non-standard, infrequent and not governed by established systems, and as such prone to human error.

To mitigate operational risks, good operational discipline and processes are required, as well as close collaboration between departments and business units. This is particularly relevant for sales, operations and risk management departments, all of which should have the same view of the transaction and collateral properties at all times. Standardized and documented recurring processes help eliminate human error in operations such as principal repayments, complex interest payment or rollovers of the structure. Finally, thorough supervision, controls and alerts help identify and rectify operational issues.

LEGAL RISK

Structured loans and collateral may require a very specific legal structure to achieve their goals. This is often only tested in cases of a default, with severe consequences if contracts and recourse are not enforceable as intended. For example, EFG, a Swiss private bank, recently lost a court case resulting in the obligation to return nearly USD200 million of collateral.[3]

Legal risks can only be mitigated by thorough due diligence and evaluation to ensure that (possibly multi-jurisdiction) pledge agreements are valid and have appropriate recourse. Previous experience in the asset class or jurisdiction is often invaluable in those cases.

[3] https://www.reuters.com/article/efg-intl-taiwan-loan/efg-shares-drop-after-taiwan-court-orders-it-to-return-193-8-mln-idUSFWN1PI0CH

INNOVATION OPPORTUNITIES

We have observed a number of innovative advances amongst leaders in structured lending. These represent opportunities for banks who are developing or starting out in this space.

DRIVING GROWTH THROUGH THE RELATIONSHIP MANAGER AWARENESS OF POSSIBILITIES

Educating relationship managers is important to heighten their awareness of products and recent developments in structured lending. This enables advisors to proactively identify suitable assets to be used as collateral and recommend attractive strategies and structures to clients. Institutions should be systematically scanning portfolios to identify eligible positions to lend against (e.g. eligible single-stocks or concentrated positions). RMs should develop a holistic view of clients' assets, particularly those not in the bank's custody (such as real estate, private equity funds or unlisted equity), and initiate financing discussions.

PROVIDING TECH-ENABLED EXPERIENCE

Technology to simulate transactions, including options for both financing and investment, can support the sales process by giving clear, flexible and customizable views of the transactions and the resulting impacts on portfolio composition, performance and risk. This improves experience and engagement for both the customer and the relationship manager.

IMPLEMENTING AGILE PROCESSES

The approval process needs to be robust but flexible and as straight-forward as possible. A two-stage approach is often helpful. Stage one involves cross-functional pre-approval committee's confirmation that collateral, loan terms and indicative financials are within the capabilities and appetite of the group. This is followed by detailed structuring of the transaction, negotiation with the client and final approval. The availability of lending product specialists to support relationship managers will expedite the process.

USING THIRD-PARTIES FOR RISK TRANSFER AND EXPERTISE

External providers can be used to take on risks that are not within the appetite or expertise of the bank. This is particularly helpful for smaller institutions who may use external advisors to assess newer and more exotic forms of collateral.

ADOPTING COMPETITIVE PRICING AND LOAN-TO-VALUE METRICS

Less conservative approach to structured lending products does not endorse excessive risk-taking, but rather provides more realistic and competitive evaluation of collateral. Banks should also create fast-track processes and streamlined approvals for lower-value and more standard transactions.

ACCEPTING A WIDER RANGE OF COLLATERAL TYPES

Recent additions to structured lending programs have included private equity, unlisted equity and commercial real estate. In the future, more banks could also consider accepting marine and aviation assets, art, life insurance, not to mention the rapidly growing asset class of cryptocurrency and other digital assets such as ICO tokens. An increased range of collateral provides a closer fit to clients' needs as well as strong differentiation from the competition.

PEER TO PEER AS AN OPPORTUNITY FOR GROWTH AND BALANCE SHEET OPTIMIZATION

The following three factors restrict a bank's ambition to launch or grow a structured lending offering:

1. **Capability** to value and manage the assets taken on as collateral
2. **Appetite** to take on board the required type and volume of risk
3. **Capacity** of balance sheet to absorb large loan positions

Loans and the collateral contribute to the bank's risk-weighted assets. This may consume capital which is both costly and limited. Even if the bank has the ability and risk appetite, it may still be limited by the capacity of its balance sheet.

To overcome these limitation, some institutions are investigating peer to peer business models. Here, both the lender (investor) and the borrower are clients of the bank. The collateral to secure the loan is held in custody by the bank, which evaluates, monitors and liquidates it if necessary. The bank takes on the role of the lead-arranger (broker), matching borrowers and investors within its client base. It also acts as administrator and safe-keeper of collateral and provider of collateral and risk management services and expertise.

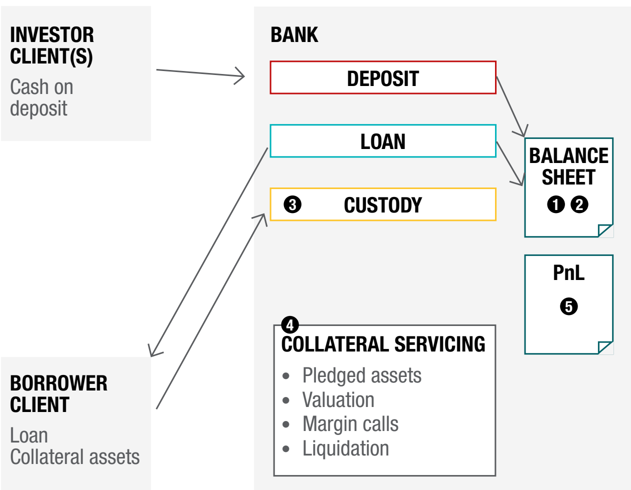
The bank has the **capability** to facilitate a structured lending loan, for which it charges a fee. The investor takes on the risk of the collateral. It is this client's risk **appetite** that drives the deal rather than the bank's. And in this setup, the investor client is at risk of losses or collateral shortfalls, so the loan can be isolated from the bank's balance sheet. This allows to overcome the **capacity** limitations.

In addition, when the cash being loaned comes from the investor-client's funds held on account (a liability for the bank), its use to fund a loan for the borrower removes it from the bank's balance sheet, reducing the bank's capital needs.

Further opportunities in peer to peer scenarios include a wide range of collateral acceptable by investor-clients - potentially wider than that of a regulated bank. This provides a new low-risk asset class for investor-clients, as an alternative to low-yielding cash deposits.

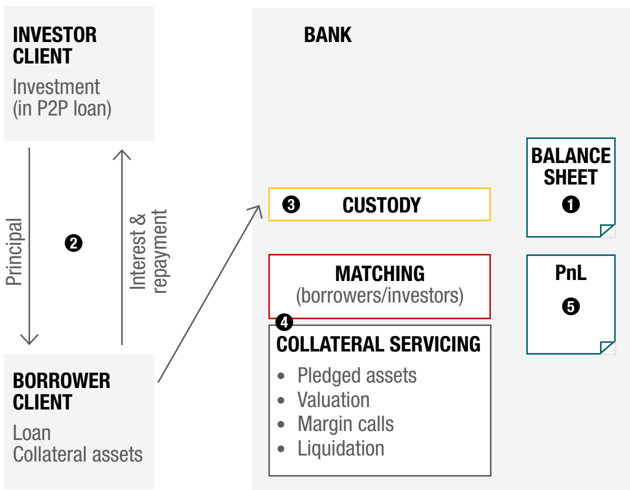
The first peer to peer offerings have started to appear in the wealth management arena and are certain to continue evolving. Capco has experience across the multiple business units and disciplines involved in structured lending programs. We can help clients evaluate the business case and implement the necessary processes and technology solutions. We believe that with innovative business models and peer to peer features, the centuries-old business of lending has entered a new era of profitability and growth.

TRADITIONAL SECURED LENDING MODEL



1. Deposit impacts balance sheet
2. Loan impacts balance sheet
3. Collateral held in custody
4. Bank provides custody collateral services
5. Bank earns interest

PEER-TO-PEER LENDING MODEL



1. No impact on balance sheet
2. Borrower and investor transact directly
3. Collateral held in custody
4. Bank matches clients, arranges deals and provides custody collateral services
5. Bank earns fees

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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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