Morgan Stanley

Fears grow over Wall St's appetite for securities-based lending

Prolonged downturn could cause problems following huge growth in SBLs

On Wall Street

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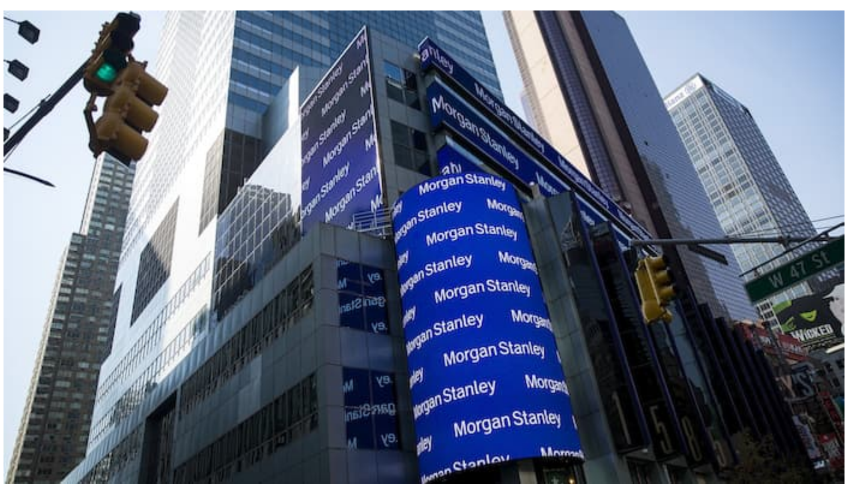
JULY 27, 2016



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by: Ben McLannahan

The brochures tend to show men in knitwear (https://boltonglobal.com/doc/Loan_Advance_Broc

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hure.pdf) on the deck of a yacht, or women stretching out with a book on a sun porch. The slogans talk of "unlocking value" and "putting assets to work". What could be more wholesome, in short, than the securities-based loan?

Such products have given a big boost to brokers' profits in the US, as choppy markets have caused trouble in other parts of their businesses. But some analysts are beginning to wonder if the SBL will turn out to be another deadly acronym born on Wall Street, in the tradition of the CDO or the Ninja loan (http://www.ft.com/cms/s/0/dbc729ba-af54-11dc-880f-0000779fd2ac.html).

The idea is simple. Wealthy customers take their investment portfolios and borrow against them, typically up to 70 per cent of the value of stocks or corporate bonds, and 90 per cent for government bonds. They then spend that money on whatever they want, so long as it is not more stocks or bonds. Maybe a tax bill or a medical procedure — or something nice such as a wedding or an apartment in Miami.

All seems fine when the market is trading like it is now, within a few points of all-time highs. But as the brokerages note — normally a little way down the marketing blurbs — there are risks. If the value of collateral falls, a credit line could be cut and the customer may have to deposit more cash or securities. Pledged securities can also be sold without a customer's consent, perhaps at fire-sale prices.

A prolonged market downturn could cause a lot of grief, given the huge growth in SBL balances in recent years. Morgan Stanley, for example, had a

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total consumer loan portfolio of less than $4bn at the end of 2010. Now it has $31.4bn (http://www.morganstanley.com/about-us-ir/finsup2q2016/finsup2q2016.pdf) in SBLs alone, up almost a quarter from a year earlier. At Raymond James, one of the top regional brokers, SBLs were up about a third (http://www.raymondjames.com/pr/160720.htm), year on year, to $1.83bn.

No one is sure how big the total market is. The Federal Reserve does not keep tabs on SBLs and neither does Finra, the self-regulatory body for the securities industry.

But people say they are looking out for abuses. Finra has put out several alerts (http://www.finra.org/investors/alerts/securities-backed-lines-credit), the latest with a long list of questions customers should ask themselves before taking out a loan. The Massachusetts securities regulator is probing SBL sales practices at Morgan Stanley, asking if teams of advisers have been pushed too hard to increase volumes.

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>
> **Josh Brown, Ritholtz Wealth Management**

In a statement, Morgan Stanley said: "We adhere to very high suitability standards regarding these loans and do not have sales contests (http://nypo st.com/2016/03/02/morgan-stanley-sales-contest-raises-conflict-of-interest-concerns/)."

It is a bad sign that banks are hiring SBL specialists like an "assembly line", says Josh Brown, chief executive of Ritholtz Wealth Management in New York. He likens a flurry of job ads on LinkedIn to the pre-crisis boom in structured credit, when banks did well by persuading customers that the products could not fail.

"I don't think a lot of investors understand that it is entirely possible for bonds and stocks to drop at the same time for multiple months," he says. "It doesn't happen often, but we're in uncharted territory at the moment. Who knows?"

For now, though, wealth-management units will keep pumping out the SBLs. Executives love them because it keeps portfolios where they are: clients cannot move assets to another group if there is a loan secured against them.

Better still, the broker gets a secondary stream of revenue from the same pool of assets. At UBS, for example, clients are offered a line of credit (http://financialservicesinc.ubs.com/staticfiles/faw/adobe/all/Lending_Circular.pdf) of between $250,000 and $499,999 at 3.875 per cent over 30-day Libor. If the client wants at least $10m, the spread drops to 1.750 per cent. When the benchmark 10-year government bond is yielding about 1.5 per cent, this clearly seems an opportunity too good to pass up.

But to Paul Meyer, a Los Angeles-based principal and testifying expert at the Securities Litigation and Consulting Group, the rapid growth of SBLs is bound to end in tears. “Bad conduct” is occurring every day, he says, but it will stay hidden until a “catastrophic” drop in the market prompts forced liquidations and claims that the SBLs were mis-sold.

In Puerto Rico, he notes, wobbles in the territory’s bond market in 2014 caused trouble (http://next.ft.com/content/37e9622e-6391-11e4-8a63-00144feabdc0) for brokers including Charles Schwab and UBS. It also turned out that some Puerto Ricans had used SBLs to buy more bonds — in direct contravention of the terms of the loans.

For the rest of the US, he warns, “the shoe has yet to drop”.

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