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Understanding the Risks of Securities-Based Lines Of Credit

Securities-based lines of credit (SBLOCs) can be a useful and convenient form of borrowing given its ability to provide easy access to liquidity while staying fully invested in the market.

We think it's important that advisors have a solid understanding of the products they offer, and that includes understanding their risks. We've highlighted below five important things to know about securities-based lines of credit.

Risk 1: SBLOCs generally have adjustable interest rates. This means interest payments can increase if the benchmark rate rises.

The interest rate charged typically adjusts over time based on a formula that uses a widely available benchmark. For instance, the rate might be adjusted monthly based on a fixed spread over the 1-Month London Interbank Offered Rate (LIBOR). The interest you pay will rise or fall based on shifts in this benchmark rate.

***Tip**: SBLOCs are best used for shorter term funding needs (generally anything from a few months to a few years in duration). Longer term financing needs (e.g., purchasing a home) are generally done differently, often using fixed rate loans. When considering whether to offer securities-based lines of credit, evaluate the expected cost of the loan over the period that your client needs the liquidity against the expected costs of selling securities to fund that need. These costs include the expected or typical return associated with those securities (e.g., the cost of being out of the market), the transaction costs from selling and rebuying the securities later on, and any tax implications from selling. If rates are expected to rise, make sure to consider the market returns of those assets in a rising rate environment.*

Risk 2: A market drop could result in a call for partial repayment or additional collateral—or even result in the lender selling some holdings.

Every security has a lendable value (e.g., the amount you can borrow using that security as collateral), which is an amount less than the market value of the security. So $100 in stock may have a lendable value of $65. A drop in the value of pledged collateral may trigger a "maintenance call" because the lendable value of the securities in the collateral account has fallen below the amount borrowed. This means the borrower may have to deposit more collateral, sell securities to raise cash or pay down some of the outstanding debt. If the borrower doesn't meet the maintenance call in the allotted time frame (usually 3 business days), the lender may take action to sell some securities in the pledged account. A sale of pledged securities could trigger trading costs as well as a potential tax liability.

***Tip:** The best way to avoid a maintenance call is to hold more collateral in the pledged account than is required—or, looking at it the other way, borrow less than the maximum available. A borrower might also keep additional securities or cash in another account to be available to move into the pledged account if needed. The advisor and borrower should monitor the value of the pledged account against the level at which a maintenance call would be issued.*

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Risk 3: A change in the collateral account's asset allocation or the characteristics of individual holdings could result in a reduced borrowing capacity.

Some lenders allow borrowers to continue to trade in the collateral accounts, but this means changes in the account could lead to a lower lendable amount. For example, if the borrower shifted a portion of the pledged account from short-term Treasury bills to stocks, the lendable value of the collateral may decline. A lender also might not accept some types of securities for pledging. And the lendable amount could fall due to a change in the risk of a particular security, such as if a bond declines from investment-grade to a speculative credit rating or a stock's price falls below a minimum threshold.

Tip: *Borrowers should broadly understand their lender's rules upfront. And as noted in the section above, borrowers should consider holding more collateral in the pledged account than is required or, looking at it the other way, borrowing less than the maximum available.*

Risk 4: The onus is on borrowers to figure out when to repay the principal, since required payments are usually interest-only.

SBLOC borrowers may be required to make regular payments that consist only of interest. They decide when to repay the outstanding balance, and as a revolving line of credit, can re-draw on the line if there is sufficient collateral.. That is different from some other types of loans, such as most mortgages, in which part of each payment is allocated to principal repayment. In either case, SBLOC borrowers can pay towards the principal or pay off the line of credit completely as needed.

Tip: *A borrower should have a plan for repayment upfront. If an SBLOC is used to bridge from a cash need today to an expected cash inflow(s) in the future, that planned cash inflow(s) should be understood. For instance, the expected cash flow could be from the proceeds of a home sale or the maturation of a bond. In other cases, a borrower might plan to pay down the outstanding balance in regular increments from salary or business or investment earnings.*

Risk 5: Pledged collateral may not be able to be removed or the accounts closed without the lender's permission.

The lender will receive a pledge of the collateral account when making a SBLOC. This means that collateral cannot be removed, including in some cases interest or dividends received, without the bank's written permission. In addition, if a borrower wishes to close the account (for instance, if moving to another investment advisor), the borrower may need to repay the loan in full before the account can be released by the bank, allowing the collateral to be transferred.

Tip: *Lenders may pre-authorize release of dividends and interest paid on collateral in the account. Also borrowers should consider keeping sufficient cash outside of the account to cover their near term cash needs. And if a borrower decides to move investment advisors, the new advisor may have a process to pay off a loan at another institution to allow the collateral to be moved, as long as that collateral is pledged to them once it is released.*