

# Securities-based lending: An alternative source of funding

By Adrian Skiles, GML

You may have heard the term "stock loan," "stock-secured financing" or "securities-based lending." All of these terms refer to the type of lending program where the borrower's securities (stocks, bonds, mutual funds or options) are pledged as collateral for a loan. These are "non-purpose" loans and no lien is placed upon any asset, such as real estate or personal property. The securities alone stand as collateral for the debt. Proceeds of the loan may be used for any purpose except to purchase or carry securities.

Interest rates for these programs are usually between 2.5 and 4.5 percent and the loan-to-value ratios offered may be as high as 80 percent of the securities value. The factors that determine the rate of interest and the amount of the loan are how actively traded and liquid the securities are on the open market. The loan term is typically between three- and 10-years, with a fixed interest rate and "interest-only" payments due to the lender. These loans are offered with no closing costs, broker or transaction fees. Funding can take place in just a matter of days. A credit report is not required, nor is any income or employment verification done.

Not all types of securities may be used as collateral. The securities must be able to be "free traded" without any restrictions and the borrower must be able to prove that they are not a 10 percent or greater holder, director or executive officer in the company that is the issuer of the securities. Retirement funds (401k's, pensions, etc), do not qualify for this type of program.

These are also "non-recourse" loans, so if the borrower does not make the interest payments when due or fails to repay the principal at the end of the loan term, the lender's only option is to keep the securities that were pledged as collateral. Should a loan default occur, the loan is cancelled and the borrower keeps the money received from the loan and the lender keeps all interest in the securities. The loan default is not reported to any credit bureau or placed in public record.

The loan application process is quite simple and should take just a few days to complete the loan process and receive the funds. To start, the borrower supplies the name and number of shares that they wish to pledge, along with the loan amount and term desired. The lender will then do a preliminary examination of the loan request, and based upon an assessment of risks, they will determine the loan-to-value ratio, along

with a proposed interest rate.

The terms are offered to the borrower, and upon agreement by both parties, the loan documents are drawn up and arrangements are made for the securities to be transferred to a holding company. A final value is then given to the securities based on an average of the closing price of the collateral for three consecutive market days. This is called the "strike price." The borrower then transfers the ownership of the securities to the lender. The borrower still retains all beneficial interests in the securities and will receive any dividends or interest that accrues from the securities during the term of the loan.

At the end of the loan term, the loan may be renewed, refinanced or paid off. If the loan is paid in full at the agreed upon term, the exact number of shares or collateral initially pledged is returned to the borrower. One important point is there is a "lock-out" for the term of the loan, which means the borrower may not make any principal reduction payments or pay off the loan entirely until the end of the agreed-upon loan term.

If, during the term of the loan, the value of the securities falls below the agreed upon minimum fair market value (usually 70 to 80 percent of the loan amount), then the loan would be considered in default. The contract may require the borrower to contribute additional

cash or shares as more collateral to keep the loan out of default. The decision to move forward is solely up to the borrower. Remember, that this type of lending is non-recourse, so should this type of shortfall occur, the borrower may stop making the payments and simply walk away from the loan and forfeit their collateral with no penalty or recourse from the lender.

When choosing a lender, here are a few items the borrower may want to consider prior to entering into this type of arrangement:

- ❖ How long has the company been in business?
- ❖ What are the backgrounds of the principals in the company?
- ❖ What assurances can the company give that the full amount of collateral will be returned to the borrower upon completion of the loan term?
- ❖ What is their track record of returning the pledged collateral to the borrower at completion of the loan term?



*"These loans are a 'qualifying stock lending agreement' and therefore a non-taxable event with respect to any gain or loss at the time of the transfer of the securities."*

# Third-party originations: What the future may hold

By David Walden

*The views and opinions expressed in the following article do not necessarily represent the views and opinions of NMP Media Corp., its publishers and staff, the National Association of Mortgage Brokers and the National Association of Professional Mortgage Women.*

When offering my opinions on the subject of the future prognosis for the mortgage broker industry, I have only one agenda and that is how to save the mortgage broker industry. I certainly do not speak for the Mortgage Bankers Association (MBA) as a trade group spokesperson, but I am offering uncensored straight talk from real experience. I'm entering my 39th year in this business, and until eight months ago, I co-owned a third-party wholesale operation that was also a division of a federally-chartered thrift. I am a mortgage banker, and I exchange knowledge and ideas almost exclusively within mortgage banking circles from board rooms, management retreats, and lounges at industry trade shows, the office water cooler, telephone, e-mails, and inner-industry trade publications.

It is a complete mistake born of misunderstanding to believe mortgage bankers want to completely re-assume the responsibilities of meeting the total demand for mortgage originations. In the late 1980s and early 90s, mortgage bankers basically gave birth to the mortgage broker industry of today because the business cycles of originations, coupled with almost uncontrollable losses in other business units of bank-owned mortgage banks, forced the reductions of overhead associated with the mortgage origination platforms. We avoided incremental overhead (on the balance sheet) by using outsourced overhead (off balance sheet) thanks to the brokers.

When we come out of this "meltdown" there is very possibly going to be a fairly rapid ramp-up of business demand for real estate financing, especially because the downside has been so protracted. Realtors are tired of starving and pent up demand from consumers previously frozen with fear will give them the opportunity to get back on the road to prosperity. The same holds true for homebuilders. Everyone in this business, and all allied business groups, are going to be even more hungry than today! There will be pressure on new product development to assure that the American dream will again be within reach for most Americans who wish to own a home. Five major banks will own in excess of 65 percent of all mortgage servicing rights and while Troubled Asset Relief Program (TARP) funds have mitigated the

effects of their shrinking net worth resulting from runoff, those lenders will need to stem the tide of rapid runoffs as quickly as possible for their stockholders. There will be limited servicing available to purchase at cost-effective prices. Therefore, it must come from production. Their own existing production operations will soon prove to be insufficiently staffed and trained to meet this demand. This industry has lost a lot of its trained, seasoned human resources from the production side of the business. We will absolutely need the surviving community of mortgage brokers to help generate the volume required to stem the servicing portfolio runoff once this cycle turns upward!

Yet today, their very survival is being threatened by program eliminations, closings of wholesale lenders, mortgage insurance restrictions and new legislation. Why? Over the past three years, mortgage bankers have been perpetually analyzing what went wrong in each file that began failing our performance expectations, including the "what/why/who" of each file. The analysis of data across the total industry indicts the broker more than any other origination group.

In my opinion, the compensation structure of most mortgage brokerages is the number one factor that compromises the ethical focus of the origina-

tors. Number two is poor or non-existent supervision, and number three is the absence and/or enforcement of traditional quality control practices, both of which are prevalent at the significant number of poorly-managed mortgage brokerages when compared to the more structured, rules-based culture typical of a mortgage bank. Not at the trade association level, but within the individual businesses themselves. Servicing mortgage bankers conduct the origination business for the servicing rights of the loans. They don't want to put defective business on their books because it doesn't perform and contaminates their portfolio or securities. They certainly don't incent their originators to break the rules and will not hesitate to terminate production personnel found to be involved in fraudulent activity. That includes fraud by omission or commission. They typically pay the lowest commission rates of all origination platforms. If one of their originators seeks to achieve gross earning levels comparable to those working in other origination platforms, they must create that opportunity through higher volume. Non-servic-



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