By Andre Cappon, Guy Manuel, Stephan Mignot

Credit and Banking: The New Frontier for Securities Firms

Broker/dealers are starting to market credit products through financial advisors, and it's good for everyone: the firms, the advisors and the clients.

In the last few years, a quiet revolution has gotten underway in the securities industry. Traditionally, securities firms focused on the asset side of their clients' balance sheets. They are now discovering the liability side and its tremendous promise.

The securities industry has evolved and reinvented itself several times in recent history. Twenty-plus years ago, brokers sold stocks and bonds and earned mostly commissions. In the mid-1980s they started selling a lot of mutual funds, earning sales loads and trail fees. In the 1990s, brokers re-positioned themselves as financial advisors, and the firms' product mix evolved towards managed money.

Increasingly firms seek to evolve their revenue mix away from volatile, market-dependent commissions towards "annuitized revenues," fees for advice (financial planning, asset allocation, selection of asset managers) and other services.

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In the context of this annuitization of revenues, credit and banking services are playing an increasing role. In the last five to six years, net interest income has grown from zero to around 10 to 15 percent of revenues for major brokerage firms. Securities firms earn this net interest income by offering an increasingly full service line of credit as well as banking products to their clients. This is good margin business for securities firms:

- Traditional asset-side business generates around 1 percent of assets under management (AUM) in gross revenues. Broker payout is around 40 to 50 percent of revenue. The firm makes 0.5 to 0.6 percent of AUM.

- On liability-side business, the firm can earn a net interest margin (spread of interest earned versus cost of funds) of 2 percent or more, depending on the product. Broker payout for credit and banking products is still relatively low, but evolving. Credit losses are negligible, since almost all brokerage-firm lending is collateralized.

- For some lending products (mortgages, credit cards), securities firms might use an outside provider and thus would be paid a commission.

You might think win-wins just don't exist—in any industry. But offering credit products through a financial advisor really is good for everyone involved—it's a compelling value for the client, the advisor and the firm.

For the client, secured credit is a smart way to borrow.

- Since collateralization practically eliminates credit risk, the client can increase his borrowing capacity, reduce his interest cost and reduce or eliminate down payments in the case of mortgages.

- In addition, the client gets personalized service from the advisor, a faster turnaround than at the bank and simplified paperwork.

For the advisor, credit and banking products generate steady payout and, more importantly, help cement the client relationship.

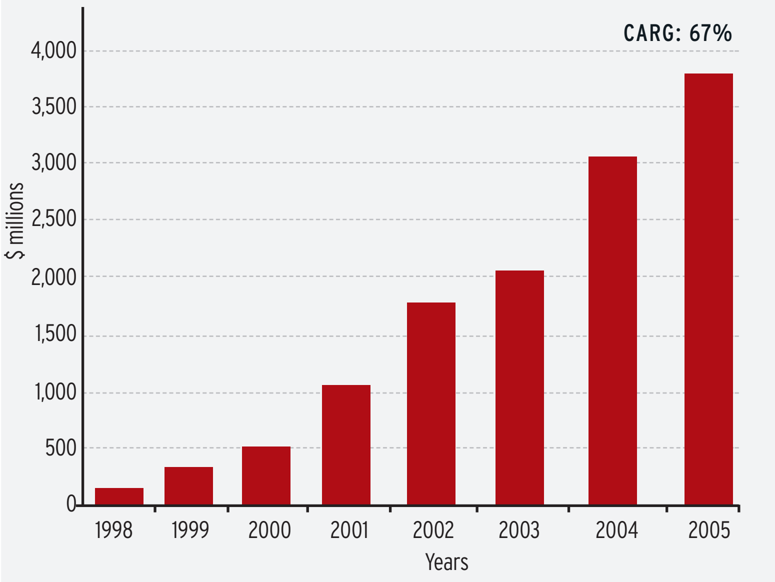
- By serving the client's liability side, the advisor gets a more comprehensive view of the client's finances and more cross-selling opportunities.

- By offering mortgage loans, the advisor can hope to cement a long-term relationship with the client.

- In addition, since the client's overall credit limit is tied to the assets held at the firm, the advisor can more easily encourage the client to consoli-

NET INTEREST MARGINS: UP AND UP

Net interest margin revenues at the top eight banking subsidiaries of securities firms grew 67 percent from 1998 to 2005.



Source: Company reports; CBM Group Analysis

date more business (either personal or linked to a small business) with his securities firm.

For the b/d, credit and banking services offer a number of advantages.

• They represent annuitized business that is not subject to market volatility and has high margins.

• They can help the firm increase customer share-of-wallet: Firms can offer more low-cost credit when clients bring them more assets, which serve as collateral.

• They support stronger, stickier, client relationships: Clients with multiple products at the firm are less likely to take their business elsewhere.

• They offer enhanced cross-selling opportunities, thanks to more insight into the client's entire balance sheet.

"Financial advisors are best positioned to understand their clients' borrowing needs and preferences," says Bill Sappington, senior managing director and head of Private Client Lending at Bear Stearns (and one of the pioneers in the area of securities firm lending). "When you consider the innovative credit products and capabilities available to financial advisors today, it is easy to see why more and more clients are turning to their brokerage firms for lending solutions."

Not surprisingly, credit and banking services have developed at a fast pace. Just take a look at the graph entitled, "Net Interest Margins: Up and Up," showing booming growth in net interest margin revenues in the eight years through 2005 at selected securities firms.

The firms have gotten creative with their credit product offerings and marketing approaches (See table, "Who's Got What"). Merrill Lynch, for example, was the first to offer a mortgage with zero down payment: the "Mortgage-100." The traditional down payment (20 percent of loan value) is itself a securities-based loan. In terms of marketing, firms have successfully integrated their credit and banking selling approach within their overall customer segmentation philosophy.

Morgan Stanley's strategy illustrates this well. The firm drops clients into one of two segments: high-net-worth individuals or "Platinum" clients, who typically have assets at the firm of over $1 million, and affluent or "Gold" clients, who typically have between $250,000 and $1 million in assets with the firm. Platinum and Gold clients get a variety of advantages ranging from more personalized

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service to lower fees and lower interest rates on credit products. This is obviously designed to stimulate clients to grant more of their wallet share to Morgan Stanley.

"Morgan Stanley is making credit products part of our relationship pricing and benefit programs," to enhance credit product distribution, says Ram Subramaniam, the managing director in charge of lending and banking. "Our goal is to enable our financial advisors to address the liability needs of their clients and manage their full balance sheet." Morgan Stanley includes loan balances (on an equal weighting with assets) in determining Platinum eligibility. For instance, a client with $500,000 in investable assets and $500,000 in loans meets the Platinum minimum requirement of $1 million.

Morgan's approach has been effective so far. Clients have realized that it makes sense to consolidate their business at Morgan Stanley, in exchange for which they get a higher credit capacity, a lower interest rate on their loans and the overall Platinum status and service.

To sum up, credit and banking services are the latest hot trend in the securities industry. These products have only emerged during the last five years or so and their growth has been impressive (over 60 percent in the last 7 years). But the penetration of credit products remains low, according to our estimates (See table, "A Drop in the Bucket").

The low penetration rates suggest that the securities industry has so far only scratched the surface of this lucrative new market. The securities industry has proven it is well equipped to provide innovative, attractively priced credit services to its customers. For the time being, the industry has focused on high-net-worth clients, but technological innovations will allow brokerage firms to offer similar services to the mass market as well. The banks better watch their backs.

The CBM Group is a New York-based management consulting firm specialized in the securities industry (www.thecbm-group.inc)

A DROP IN THE BUCKET

Market penetration rates for credit products is still very low.

Product	% Market Penetration
First Mortgage/ Home Equity Line of Credit	Up to 3%
Commercial Loan	Less than 1%
Commercial Real Estate	Less than 1%
Securities-Based Loan	Up to 3.5%

Source: CBM Group analysis

WHO'S GOT WHAT

The Major Wall Street Wirehouses Offer a Range of Different Products

Product	Merrill Lynch	Smith Barney	UBS	Morgan Stanley
First mortgage /home equity line of credit	Yes	Yes	Client referred to Wells Fargo	Yes
Non-purpose loan, collateralized by client assets	LMA (Loan Management Account) flexible loan product collateraliized–usually at 50% rate_by securities	Express Credit Line	Prime Credit (<$500K) Premier Credit Line (>$500K) Loans also count toward Gold/Platinum status	PLA (Portfolio Loan Account)Flexible loan product, collateralized usually at 50% rate–by securities, which counts toward Gold/Platnum status
Core banking product	Cash Management Account		Central Asset Management Account	Cash Account