How FPL Can Help Create Sticky Clients

The attractiveness of a fully paid lending program
The era of client portals, cloud mobility and self-serve models for client management is upon us. While this may be good for the operational bottom line, it is having a domino effect on customer retention. Given that the issue of the “slippery client” is on the rise, many financial firms have shifted priorities from increasing their books of business to keeping the clients they have. If there is one word that defines trending business goals of financial services firms, it is “stickiness.” All financial services firms are looking for ways to entice clients to remain loyal customers. For buy-side, sell-side and wealth-focused firms, there is increased momentum behind fully paid lending (FPL) programs to help achieve this goal.

WHAT IS FPL?
While FPL will be new to many, the business model is not. Formerly the bastion of institutional books of business in a securities-lending role, the FPL concept is now being employed on other long-only portfolios, such as high-net-worth books of business.

The concept and business goals behind traditional securities lending practices are relatively simple. Historically, it has been a practice adopted by banks and brokerage firms to leverage additional income on books of business, particularly long-only positions. It has provided market makers an avenue to generate fees for institutional portfolios through borrowing and lending securities in demand as collateral and for other purposes.

The institutional investor (the lender) offers a temporary loan of a position/group of securities to a borrower (a financial institution, such as a brokerage firm, bank or hedge fund). The loan generally has an intermediary who facilitates the transaction (broker/lending agent). Agreement on the terms of the loan, how the lender is paid and the revenue are all shared, as well as any other relevant details, and captured into a loan agreement.

IS FPL TRENDING?
The short answer is yes. FPL is trending. But the factors shaping its increased usage help clarify why. Given the advantages of FPL a decade past the subprime crisis environment, securities lending is going through a metamorphosis.

Trend #1: The buy side is getting more self-sufficient in this area after decades of handing their books to custodians as lending agents for a cut of the fees. Looking for increased revenue opportunities, many buy-side firms are eliminating the third-party lending agent and dealing with brokers directly. This buy-side trend to pull securities lending in-house is subtle but impactful to the industry. However, it is only noticeable to those on both sides of the former revenue stream, so this is a very quiet revolution.
**Trend #2:** The sell-side and remainder of the traditional borrower markets in securities lending (banks, hedge funds) are looking to target pools of securities to help expand their desk activities in securities lending. As baby boomer retirement pools are growing, it has become an area of increasing interest for sell-side firms to establish securities lending relationships with sophisticated investors.

**Happenstance trend #3:** As the sell-side pushes the envelope a bit further into the high-net worth of boomers and retail pools looking for sophisticated investors (especially for pools like hard-to-borrow stocks), the wealth sides of the financial services business are looking for ways to keep their clients happy.

In the era of disruptive technology, repapering with another firm has become easier. Loyalty is being tested by wooing business with client portals offering analytical tools, transparency and the ability to drill down into portfolio activity for a more enticing client investing experience. As wealth businesses are looking for ways to keep clients sticky and brokerage firms are looking to penetrate further into retail books, FPL programs are beginning to emerge.

**INCLUDING FPL OFFERINGS RAISES HURDLES**

FPL programs are attractive because they can service a multitude of business goals across diverse business groups in a financial services firm. However, they have some distinctions from traditional securities lending that firms need to address. Similar to any other securities initiative that migrates from institutional-only to retail investors, hurdles of dealing with potentially less sophisticated investors get a little higher as the footprint to include the average investor firm expands. Regulatory scrutiny on this area is growing in line with the number of firms launching FPL programs.

At first glance, establishing an FPL program appears to be a securities-lending business initiative. However, the mechanics to enable all the working pieces lie in other areas, including onboarding, client management, accounting, tax, reporting, compliance and legal. Any enterprise-wide initiative can be daunting to take on. FPL is no different.

**THE BUYER BEWARE LIST IS LONG FOR FPL**

The hurdles for clients of a firm contemplating FPL include:

- Education of potential investors on what FPL entails
- Repapering/onboarding them with all the caveats of being involved in an FPL program

Apart from these two core elements, a key component is raising awareness on the compensation structure for securities on loan. The legal and potential risk disclaimers and managing expectations of clients are also critical to get new FPL participants on the right track from the start.

Clients must understand the important differences between being in the program (having securities available to loan) and actually having securities on loan out of the program.

It is also important to discuss key aspects of the program, such as:

- The treatment of corporate actions
- Voting rights and entitlements while securities are on loan
- Potential reclassification of dividend income from loaned securities that may:
  - Cause tax ramifications (i.e., payment in lieu, or PIL)
  - Result in dividend income changing to cash payment and trigger tax impacts

These components should be clarified so there are no surprises for anyone – and this discussion can vary depending on the jurisdiction in which the program is established, along with other factors.
REGULATORY WATCHDOG LEARNING AS FPL EVOLVES

Given that FPL programs move securities lending to the retail domain, this activity is coming under increased regulatory scrutiny. Regulators are looking to ensure retail investors have reasonable financial protections and are treated as fairly as possible for allocation and execution. The rules governing FPL in various jurisdictions reflect that focus. Key examples of regulatory policy emerging for FPL programs include:

- While collateral options may become more sophisticated over time, cash as collateral, in clearly delineated accounts, is the only option for most lenders and borrowers to consider at present.

- Ensuring that clients know they are NOT covered for bankruptcy protection for securities on loan in an FPL program under SIPC, CIPF or other similar consumer-protection groups and demonstrating the paper trail on this for regulatory review is a regular theme.

- Equitable treatment for allocation and execution in securities-lending programs with other clients lending the same stock/deal requires an auditable process.

- Looking for audit trails around client handling to demonstrate equitable dealings across clients and clarity for participants in FPL programs. This includes appropriate flagging of assets, reporting in fee calculations and other touch points as recurring regulatory themes.

- Clear, well-documented onboarding materials so clients understand the nuances of securities available in their program. These should cover:
  - Corporate action/tax impacts
  - Whether investors who lend their shares are allowed to continue to trade as usual and sell them at any time without prior notice
  - The stipulations and issues surrounding unwinding from an FPL program in whole or in part.

Like any securities-industry initiative in its early stages, FPL is ramping up for competitiveness. Firms are starting with entry-level programs for FPL, but will evolve in the coming years. More entrants will push existing players to create options to further entice existing clients to stay sticky. Hand in hand with this revolution will be the evolution of regulatory readiness threshold. These thresholds are likely to have different flavors across jurisdictional boundaries that must be incorporated for robust, global FPL offerings.

Early adopters of FPL programs may benefit from less onerous scrutiny for approvals to start a program, but the rules will evolve with more entrants. While this may give some firms a competitive edge in the early days of mainstream FPL, neither entrants nor participants in FPL programs anticipate these early-adopter approvals will be grandfathered. While movements on this front to retrofit the first firms into this space are still pending, some alignment should be anticipated at a future date.

MONEY FOR NOTHING

While these may seem like high barriers to entry for firms bullish on setting up an FPL program, the good news is it is not an uphill struggle to sell FPL to clients. For many retail investors with long-only strategies, FPL programs provide an opportunity to earn additional income on positions in their portfolios without any action on their part other than signing up for the program. This makes the conversation on signing up much easier. We are unsure the members of Dire Straits had this concept in mind when they penned the song "Money for Nothing" in 1985, but it seems a quite fitting analogy for many long-only portfolio strategy participants who understand the business risks.

MULTI-TASKING BUDGET SPENDS ARE A HAPPY BY-PRODUCT OF FPL BUILD-OUTS

Any time an initiative can demonstrate it can service opportunities in multiple areas of the business from a single spend, it ascends the priority list for approvals. While business cases for FPL initiatives are complex to assemble, alignment on approvals is easier to obtain with a cohesive end-to-end picture and story. The program may be rolled out in increments over a longer period of time. However, assembling the planning pieces up front with a combination of current and sequential activities for the rollout are the most common and successful approaches to establishing FPL programs, while minimizing risk.
WE’RE JUST NOW CONSIDERING FPL. ARE WE EARLY OR LATE ADOPTERS?
The short answer is that it depends on the marketplace where you plan to initiate an FPL program. Canada is on the verge of a major launch in the FPL marketplace and the U.S. is entering the second generation of FPL. Multi-jurisdictional offerings are anticipated as a next major step, but this area is still in its early stages.

Regardless of jurisdiction of origin (which is primarily Canada, the U.S. and U.K.), FPL programs are extending into client portfolios and searching for revenue-generating opportunities and attractive client offerings across local and international jurisdictions. As these programs continue to expand cross-border, regulatory bodies in impacted regions will assess effects on investors and retail participants in their own regional markets for this global exposure.

KEEPING CLIENTS STICKY V2.0
While we are in early days of a large competitive market for FPL programs, a shift in gears to the next level of sophistication is on the horizon. Fee structures are the obvious target for keeping clients sticky, but the nature of FPL programs themselves facilitates other options for competitive offerings:

- Exception-based FPL participation rather than all-inclusive. Some offerings of FPL require all or none as participation criteria. However, exception-based participation opportunities for clients is anticipated to be better subscribed as time evolves. This will allow customization of long-only versus actively traded portions of client portfolios. The result is greater opportunity to enhance revenue more selectively or allow for other limitations clients may want for allowing some securities in an FPL program.

- Penalties for exiting FPL programs. To encourage loyalties and increase stickiness, penalties for exiting a program will likely reduce over time as competition in the marketplace will drive fewer firms to place onerous restrictions on participants.

- Creativity for collateral options for securities on loan. Cash is currently king on the collateral front for FPL portfolios in many areas (and the only collateral option available in some jurisdictions at the time of this writing). However, as FPL programs become more commonplace and regulatory bodies and market participants fully understand how they work, regulators may grant more leeway and there may be more acceptance by lenders on collateral substitutions. While this is not anticipated in the near future (especially in some marketplaces), it will evolve as the natural competition in the FPL marketplace expands in the coming years.

- Minimum participation and cash balances will lower. Similar to the marketplace targeting high-net worth clients the industry saw over two decades ago (i.e., “We won’t seek anyone in our program with less than $1 million in assets under management.”), thresholds will drop. Tolerance on lower end-limits for FPL participation will change with market saturation of high-net worth FPL players, competition and adoption. The evolution, adoption and use of sophisticated technology for client aggregation, drill-down views for transparency into client pools and marketplace availability (and demand) as well as for allocation back to client accounts will lower operating costs and enable viability to service smaller accounts with a profitable model.
SORTING THE FPL PUZZLE
While early adopters of FPL programs are in the U.S. and Canada, and the marketplace is a little more established in the U.K., many new entrants are ramping up to enter the business. Much like solving the famous Rubik’s Cube puzzle, assembling the technology and operational work flows to develop a competitive offering that also meets regulatory concerns can be daunting. This complexity is heightened as firms begin adopting a multi-jurisdictional model for global rollout.

As mentioned previously, many of those charged with the task of adopting an FPL program in firms often have an operational or securities-lending desk role. Before a firm seeks approvals externally with regulatory bodies to enter into a program, it must build its capabilities (and often approvals) from business units up and down the food chain. This includes those responsible for managing clients and the books of business in the firm. Legal counsel often represents the first gauntlet that must be passed as lawyers strive to protect the firms’ exposure and that of its underlying clients.

Achieving internal buy in for an FPL program involves a clear assessment of the potential market size from the firm’s existing clients. The number of potential new clients that could be attracted by the program can then be added to the assessment. This calculation helps to persuade internal stakeholders that the investment in an FPL program could be profitable for the firm and under what conditions.

THE PUZZLE OF FPL PROGRAMS

TOP FIVE COMMON MISTAKES FIRMS MAKE IN LAUNCHING FPL
• Assuming the heavy lifting for FPL technology and operations is in the securities-lending desk’s areas
• Underestimating the end-to-end internal buy-in effort across departments to get an FPL program launched
• Assuming the regulatory path to approvals to establish an FPL program is straight-forward
• Underestimating the effort to set up and run a multi-jurisdictional FPL program due to regulatory and securities handling differences in different regions
• Underestimating the education and onboarding effort required with high-net worth and retail clients to embark on an FPL program

CONTACT US
For more information or to obtain FPL checklists help with this process, please contact us.
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