



# “The Bank of You”: Pros and Cons of Securities-Based Loans

## Key Takeaways:

- Securities-based loans can be a low-cost way to access cash quickly.
- You can maintain your investment positions and possibly mitigate taxes, too.
- Margin calls and various restrictions are a few of the downsides of these loans.

When the Super Rich—those with a net worth of \$500 million or more—want to access capital or borrow to pay for a big purchase, they often tap one of the lowest-cost sources of financing there is: themselves.

These wealthy individuals are able to quickly gather significant sums of cash by using securities-based loans—borrowing against the value of assets in their investment portfolios, often at favorably low rates. Such loans can enable borrowers to delay capital gains taxes, keep money in the financial markets to pursue growth, and fund everything from luxury second homes and vintage automobiles to ownership stakes in businesses.

You may be able to follow in their footsteps and take advantage of securities-based loans for your own spending goals. But should you? Despite their benefits, these loans come with rules and potential pitfalls that you need to understand in order to make the right decision for you.

With that in mind, here’s a closer look at the world of securities-based lending.

## IN THE SPOTLIGHT

The basics of securities-based loans are pretty straightforward—and similar in many ways to how a home equity line of credit works. Rather than sell stocks, bonds or other securities (and potentially pay capital gains tax in the process) to gain liquidity, money is borrowed against the value of the portfolio. Depending on the firm doing the lending and the risk level of the portfolio, you might be able to borrow 60 percent or so of your portfolio’s value. (That percentage can vary significantly, however, based in part on the types of assets being pledged.)



Securities-based lending is hardly a new development in the world of finance. But it's been in the spotlight in recent years, as rising equity markets and low interest rates have prompted more investors—including those without multiple millions of dollars to their name—to consider tapping into their paper wealth. Examples would be new investment opportunities, helping family members, paying taxes on stock options.

**Important:** Things you *can't* do with a securities-based loan include purchasing or trading securities, refinancing or repaying an existing margin loan, or repaying any other loan used for securities purchases.

### ADVANTAGES OF BORROWING AGAINST YOUR PORTFOLIO

Investors with enough wealth to use securities-based lending cite several reasons for choosing that route over other options, including:

- 1. Lower costs.** In general, securities-based loans tend to charge lower interest rates to borrowers than do unsecured loans and other forms of credit (such as second mortgages and home equity lines of credit).
- 2. Quicker access to cash.** With a securities-based loan, you often can get access to the funds in several days, versus weeks with a traditional loan that has to go through a longer underwriting process (such as a mortgage). That can be helpful if you need cash to serve as a bridge between two events in close succession—such as selling one home and buying another rapidly.
- 3. No impact on credit rating.** In general, securities-based loans don't affect your credit score. They typically don't require a credit check, because they're based largely on your existing collateral. And lenders usually don't report payments on a

securities-based loan to the credit bureaus. For these reasons, some affluent investors with poor credit histories might favor securities-based loans.

- 4. Avoid or delay capital gains tax.** If you sell assets to raise cash, you can potentially pay a long-term capital gains tax of 20 percent or more. By borrowing against your portfolio, however, you avoid that taxable event in favor of paying an interest rate that (as noted) is likely to be lower than the tax rate. Bonus: Because the loan is a form of debt, it's not considered income—and therefore isn't subject to income tax.
- 5. Maintain investment positions.** When you liquidate investment assets, they're out of the market and therefore can't participate in the market's returns. In contrast, a securities-based loan enables you to keep your assets invested and (hopefully) growing. And of course, if your loan interest rate is significantly lower than the return on your invested assets, you can potentially come out ahead.
- 6. Hold on to a treasured asset.** Don't want to part with a big chunk of the stock that made you wealthy? Prefer to keep that pricey painting hanging on your wall rather than someone else's? A securities-based loan can help harvest cash from an asset that is personally meaningful or important to you—without having to sell it.

### A TAX-SAVVY STRATEGY TO CONSIDER

Some investors have longer-term tax mitigation in mind when they take out a securities-based loan, via a strategy that's come to be known among the affluent as “buy, borrow, die.”



The idea is that if you borrow against a portfolio but never sell the assets backing the loan, the cost basis of those securities will “step up” at death—allowing the borrower to avoid paying capital gains taxes on the assets, as well as avoid paying taxes on the amount borrowed. What’s more, the heirs who inherit the assets start at the new, stepped-up tax basis—meaning they could potentially avoid paying a fortune in taxes if they sell.

This benefit has been the target of debate among lawmakers, so it makes sense to consult with a tax professional for the latest developments and guidance.

### RISKS TO BE AWARE OF

As is the case with just about any loan, there are potential risks associated with securities-based lending. If you consider this approach, be clear on the possible pitfalls and limitations—which can include:

- **Margin calls.** If the value of your portfolio or the pledged assets falls below a certain predetermined level, the lender might require you to add more money to your investment account. If you don’t, or can’t, the lender could liquidate some or all of your portfolio. That, in turn, could generate taxable gains you have to pay—or lock in losses that were only “on paper.”
- **Loss of assets.** Failing to make the payments on your loan could prompt the lender to take possession of your portfolio assets to cover the shortfall. This could also generate unwanted taxes. This risk could be heightened if the loan is used to purchase big-ticket luxury items that can’t

be sold quickly to raise money if you experience a cash crunch.

- **Restrictions on your portfolio.** When you pledge portfolio securities as collateral for a loan, you may not be able to engage in certain activities. For example, you may need to get permission from the lender before trading the pledged assets or even withdrawing money from the account. What’s more, you can’t use these types of loans to buy more publicly traded securities for your portfolio. For that, you’ll need a margin loan or margin account.
- **Fluctuating payments.** These loans’ rates may be based on a floating interest rate that can rise or fall—impacting what you owe each month. If interest rates spike or even march steadily higher, that can result in higher payments than you anticipated.
- **A bursting bubble.** A financial shock or crisis that hits asset prices hard could put pressure on your portfolio—and your loan that’s backed by it.

### CONCLUSION

Securities-based loans are one way to make debt work in your favor. And while you do need significant assets to use this approach, your last name doesn’t have to be Musk, Buffett or Bezos to make it happen! That said, using leverage can add risks to your overall financial picture—a fact that some investors too easily overlook. Therefore, consider your financial wants and needs, as well as your financial health and market conditions, to determine whether securities-based lending makes sense for you and your family.