Think Twice About Broker-Dealers' Forgivable Loan Offers

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Financial advisors have come to expect certain incentives from the firms trying to recruit them, and one of the biggest carrots is forgivable loans. But those loans, as common as they are, might become another casualty of the times. In fact, it might even be to advisors' advantage in the future to simply turn them down.

Part of that has to do with the regulatory, fiduciary and competitive pressures driving change in the industry. Regulators are looking closely at what clients are being charged, and in the future, broker-dealers' administrative fees could be low-hanging fruit for examiners. The structures of these fees are often opaque, the disclosures scant. Some fees provide no value to clients at all, while others show no reflection of what's being charged elsewhere in the industry. And when it's a client account funding a broker-dealer's incentive loan to an advisor, regulators may seize on it.

When regulators put admin fees in their cross-hairs, broker-dealers and RIAs will likely see their revenue curtailed—which could also blunt the size of the loans to transitioning advisors.

Broker-dealers are seeing their fees come under pressure from technological advances as well. More efficient technology could give RIA firms (and their independent advisor reps) a fee advantage that puts pressure on B-Ds to lower advisors' portfolio management platform fees—something typically paid for by clients. When it's advisors paying for the related ticket charges, which is less common, regulators will want to ensure that these advisors are trading on the actual merits of the investments they're choosing—not just trying to save themselves overhead.

One type of fee contributing to an advisor's forgivable loan is the structure known as the "rep as portfolio manager" model (or "RAPM") in which the advisor personally manages the portfolios. This model has become more popular with the advent of direct indexing and ticket-charge-free ETFs and funds. As the model becomes more widespread, the aggregate client costs across the regulatory channels are going to be monumental.

Other client advisory account types also make big fund contributions to broker-dealer incentive loans, in some cases more so than RAPM admin fees. Consider broker-dealer administrative fees for advisory accounts, turnkey asset management programs (or TAMPs), institutional custodians and third-party managers. The fees from these revenue centers have been golden for years, but many financial planners don't know whether their clients are subject to tacked-on fees from these programs. What value does a client receive from additional AUM fees charged expressly to access third-party managers? These fees can be 25 basis points, and the markups can be as high as 50 basis points for separately managed & unified managed accounts.

Trying to break down a platform's total expense can be a big challenge. And not knowing can put the financial advisor in a precarious situation: It's never been more important to know exactly what your clients are paying and why.

Consider what advisor clients pay at independent RIA firms. They might pay $50 per account per year for similar rep-as-portfolio-manager account services on a platform like Orion's, which would include fee billing, rebalancing, reporting and more.

Compare that with a $500,000 RAPM account at a broker-dealer with a 12 basis point client admin fee, which results in a $600 annual platform fee, excluding ticket charges. (Not all firms require clients to pay tickets, and most advisors now use no-transaction-fee ETFs and funds). The difference is $550 per year. Imagine the compounded growth for a client who saved that much over 10 years.

The Relationship Between Loans And Advisory Revenue

Forgivable loans are purposely constructed by issuers to collect back every dollar of the loan during its schedule, and often well before. It's not to a broker-dealer's advantage to offer a $100,000 loan to a rep over six years and leave it till the end of that time to break even. The loans are often paid back while there are still years left on the notes, which is understandable for any business that wants profitable relationships. More recently we've seen independent broker-dealer loans stretch into the 10-year range, which is an eternity in our industry.

For B-Ds to continue offering large notes, they must continue to earn large margins years into the rep relationship. But don't expect a clause in the loan agreement contract saying that existing fees can't be raised or that new ones can't be levied. Fee compression is real.

Plus, it's expensive to provide big transition packages. In fact, to protect their investments, some B-Ds have bought life insurance policies on financial planners with forgivable loans of $100,000 or more. There are also financial risks in loans that are based on time and the associated interest.

These problems shed light on the obvious conflicts of interest in forgivable notes, conflicts that become more acute when a recruit brings new advisory client assets over during their first year with a firm, triggering bonuses and calculation adjustments after the fact (adjustments known as "true-ups.")

Financial advisors are systemically encouraged to funnel advisory assets onto these platforms, which, again, will likely grab the wrong kind of attention. It could also be that advisors will be required to disclose to clients their forgivable loan amounts —and their sources—at some point, and the PPP loans taken out during the Covid-19 crisis may end up being the spark that gets this started.

For these reasons, more advisors may reject the forgivable loans and seek out firms with lower advisor and client costs. Or they might otherwise take smaller notes or grants to cover only the actual hard-dollar costs of a move.

Such alternatives allow broker-dealers and RIAs to provide a better long-term financial partnership with advisors, offering higher payouts and/or reduced fees in which the advisor nets more over time while acting in a fiduciary manner.

If the relationships with the broker-dealers are stronger for all this, it's more likely the advisors will stay with their firms, an advantage the B-Ds will appreciate at a time when firms like Vanguard are trying to capture their retail financial advice clients. These better arrangements would also make it easier for advisors to move, and ease the cost of moving their clients (depending on the custodial relationships).

Advisors shouldn't have to worry about looking over their shoulders to see which regulators are watching them. One chief compliance officer I spoke with on the topic of a questionable business practice put it this way: Just because something's allowed today doesn't mean it won't haunt you later.

As the big broker-dealers do battle, the big compensation packages are still being offered to woo advisors away. But it's these large transition packages that contribute to the debt mattress much of the industry is sleeping on.

Will all be forgiven? Time will tell.