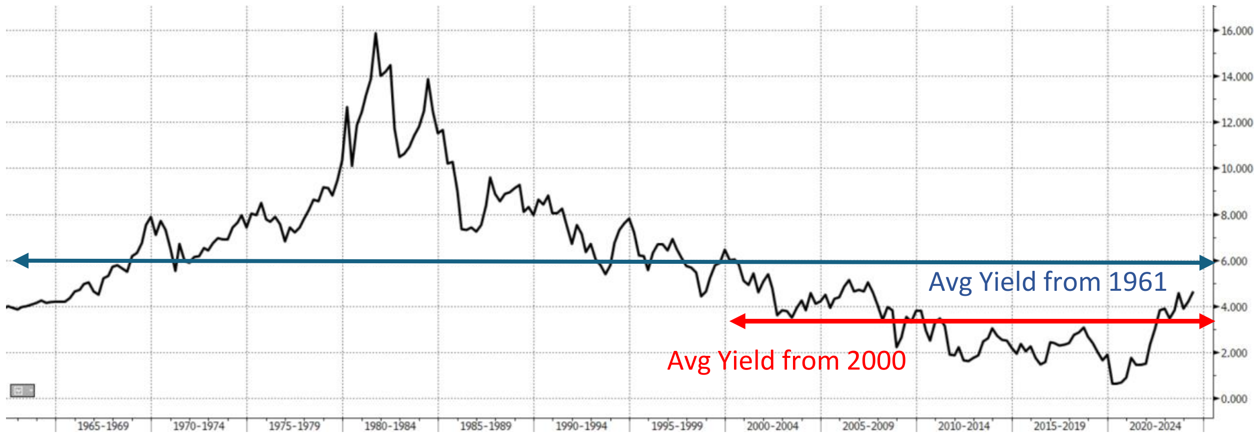
The No-Longer Anticipated Fed Cuts

In a few short months, stronger economic data (higher GDP, stronger job market, and stubborn inflation) changed the market's and the Fed's view on the future path of interest rates. The market and the Fed are now aligning on only one rate cut in 2024 – obviously this will change over the course of the year as the economic data evolves.

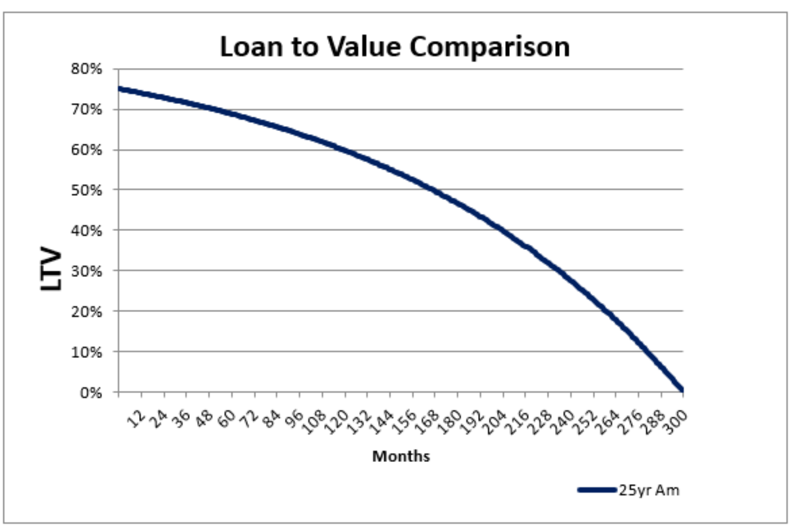
One important issue facing borrowers (and their trusted advisors – commercial lenders) is determining appropriate financing terms. We see many borrowers making the mistake of financing long-term assets with short-term credit facilities. This strategy reflects some borrowers' belief that paying a higher rate today on short-term (temporary) financing and then replacing that loan in the future at a lower cost is a winning bet.

We believe this strategy is a mistake for the following five reasons:

1. Timing the market for the lowest cost to the borrower is an impossible task for anyone who cannot see the future. The inverted yield curve is already pricing the probability that the Fed decreases interest rates in the future and a rational borrower would be indifferent (as to loan costs) between short-term and long-term financing. But there is an obvious reduction of risk for borrowers to finance long-term assets with long-term liabilities (more on this below).
2. Short-term rates are not necessarily correlated with long-term rates. Therefore, what the Fed does with the overnight rate (the index which it directly controls) has little bearing on a borrower's cost of financing term debt.
3. Long-term interest rates are not above historical averages. The graph below shows 10-year Treasury rates and average rates for two periods (from 1961 to the present and from 2000 to the present). By longer-term historical averages, current 10-year rates are low. From 2000 to the present (which includes depressed rates during the pandemic and great financial crises), long-term rates are at approximately an average level. It may be unwise for borrowers to wait for a more suitable time to secure long-term financing.

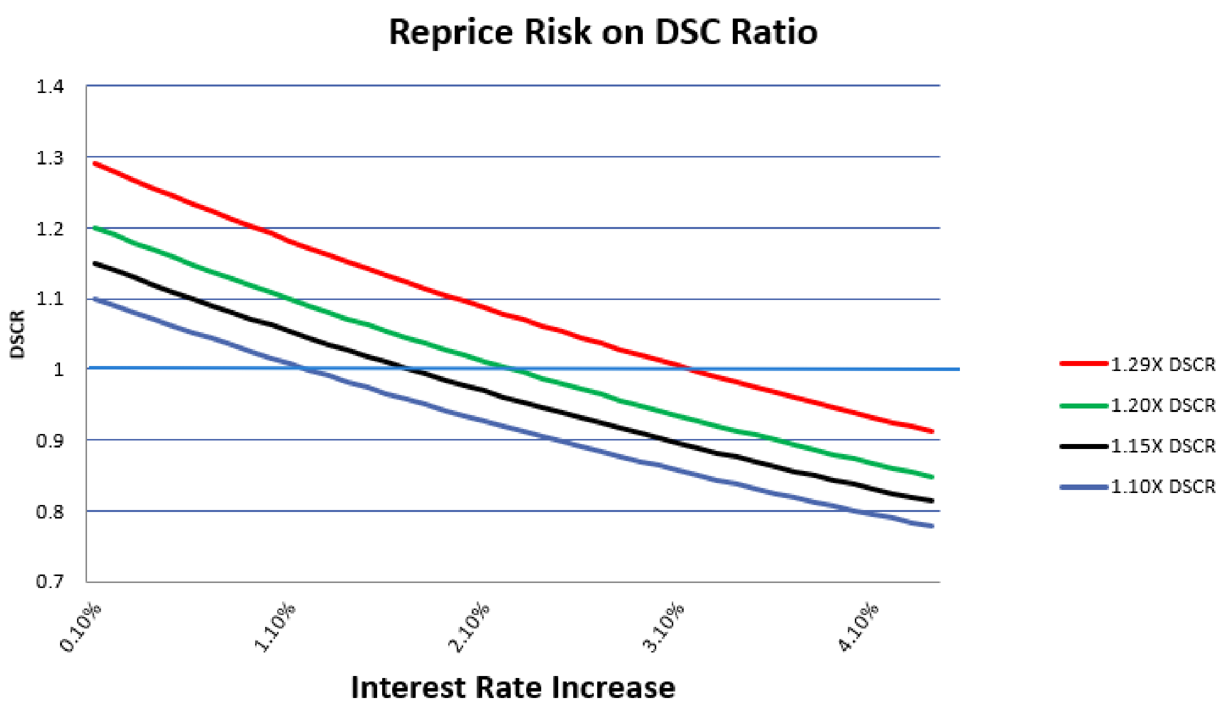


4. Short-term facilities do not allow borrowers to pay down the debt and build equity in the collateral. The graph below shows the principal outstanding as percentage of collateral value (starting at 75% LTV). The table below shows the amount of principal reduced for the respective terms. A shorter financing term creates a greater refinancing risk – when the borrower has potentially little (or no) equity in the project. Conversely, 10 and 15 year terms allow the borrower to pay down substantial amount of debt, increasing equity in the project and minimizing refinancing risk.



Term (yrs)	Principal Reduction
1	0.97%
2	2.11%
3	3.44%
4	4.65%
5	6.08%
7	9.26%
10	15.03%
15	28.05%

5. Short-term facilities expose the borrower to cash flow risk if interest rates are higher in the future when the borrower needs to refinance the temporary debt, or if the borrower's cash flow is impaired. The graph below shows resulting DSCR in the future if interest rates increase, for loans that start at 1.1X, 1.15X, 1.2X, and 1.29X DSCR. The analysis shows that projects starting with 1.1X DSCR (7.00% fixed rate on 25yr amortization) would break 1.0X if rates rise by only 99bps. A project starting with 1.15X DSCR would break 1.0X if rates rise by 1.60%, and those with 1.2X DSCR would break 1.0X if rates rise by 2.10%. Most banks want to stress-test DSCR at 3.00% higher rates, and that would require a 1.29X starting DSCR to withstand that risk and ensure at least 1.0X DSCR. In summary, short-term financing of long-term assets creates another source of risk for both the borrower and the lender.



The Solution

Lenders can help their borrowers with sound and fundamental advice. Offering longer term fixed-rate debt through a loan hedging program offers the following benefits: 1) a lower borrower's interest rate and lower periodic payment, 2) increased yield to the bank, 3) substantial fee income for the bank, and 4) future certainty of payments to the borrower. If a borrower is seeking temporary debt, lenders should additionally show longer-term pricing options (7, 10 years or longer if within policy) and discuss the pros and cons of various options. Remember that if the borrower is seeking temporary debt and betting on interest rates declining, rates decline when the economy is slowing, or in a recession, and borrowers must consider their own expected future cash flow and the possibility of not meeting bank underwriting criteria (1.20X DSCR) when a refinancing is required.

Action Item

Contact the ARC Team to obtain a presentation for your specific borrower showing the benefits of a hedged loan using various structures and terms.

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