pro@ctive™

Memorandum

To: Clients, Friends, Family & Associates of Pro@ctive CPA
From: Mark Wyssbrod, Managing Member
Date: September 24, 2011
Re: The Future of Loans & Solutions to Implement Now!

During this ever changing economic time nothing seems to work the way it should. One can conclude the results are not as predictable now than just a few years ago because the economics rules are evolving. The economic rules we grew up with and children and now as adults may not be the same economic rules we currently have or will have in the future. I believe the way we bank (financial debenture transactions) will be dramatically different in the future.

One of the five economic drivers since the early 1980s was favorable monetary policy. A part of this policy was the continued decline of long-term interest rates. During this period interest rates have declined from above 18% to almost 0%. Interest rates cannot go much lower as the floor is 0% (actual interest rates, but "real" interest rates can be manipulated lower). At some point in time interest rates will have to begin to increase. As interest rates increase, banking as we have grown accustom to over the past three decades will likely change.

First, to understand the current financial climate, let's review the motivations of a bank during a long-term period of declining interest rates. Banks, as any investor, want to maximize profits. In a period of declining interest rates financial institutions want to lock in higher rates for long periods of time. If the banks offered variable rates instead of fixed rates during a period of declining interest rates the interest portion of the loan would decrease over time. As interest rates continue to fall, the borrower is motivated to refinance the loan. The financial institutions do not mind refinancing since loan fees can be captured. Financial institutions can profit by borrowers locking in higher interest rates for longer periods of times and by refinancing loan fees.

When interest rates begin to rise, banks will begin limiting term loans. Term loans lose value as interest rates rise. Additionally, banks can re-deploy their capital to earn higher rates. As a result, financial institutions who lend monies will not be motivated to lock in low interest rates for the long term. The solution for lenders will be to set up debentures with variable interest rates. As interest rates rise, the financial institutions will be able to increase profits and not lose value on the loan amount. We can be assured financial institutions will change their loan types and standards in order to maintain and maximize profits. As several economic articles and updates have asked, who is willing to lend long-term money and only earn 2% (i.e. 10 year US Treasuries are currently yielding ~2%)?

A few bankers have ensured me a change to variable interest rate loans would never occur. Their reasoning is banks match long-term loans issued with loan-term loans borrowed from the US Federal Reserve. This locks in their profit margin. I believe the banks profit motives will be stronger than this simple example and the banks will borrow loan term at low rates and then loan the money on variable rates in order to increase profit margins over time. Profit motives trump everything for banks!

The solution for borrowers is to lock in low interest rates for the long-term. Borrowers should lock long-term loans and interest rates in before these changes take place. The financial institution will be swift to change their lending behavior as interest rates begin to rise. I believe borrowers have through the end of 2013 (perhaps 2014) at the latest to lock in interest rates. It seems far away, but it will be here before you know it!

Some other loan concerns include loan covenants. Loan covenants are conditions the borrower must abide by during the term of the loan. Some conditions can be debt-to-equity ratios, liquidity ratios and working capital. On the horizon, Accounting standards are about to change. There is a movement to change US Generally Accepted Accounting Standards (GAAP) to International Standards. The transformation will move US GAAP financial, which report on a historical cost basis, to a new fairer market value basis. A part of the changes will be how we account for assets and debts. The new accounting methods will affect financial ratios and, more than likely, reduce liquidity measurements by increasing debt measurements. At the time of the conversion, many companies will be in violation of loan covenants. The solution is to have all loan documents (new and amendments to current loans) to be based on current US GAAP even when standards change.

In this fast paced and quickly changing world, we can be sure the rules of business will evolve. Business must make intelligent long-term strategic decisions, but maintain short-term flexibility and understand long-term strategic decisions need to be updated and revaluated on a regular basis. A long-term strategic decision can be to reduce debt terms and interest rates and to determine the best long-term course of action. This may be to review loan covenants and to lock in low interest rates for the long-term.

In a world of fast paced change, nothing we are accustomed to will stay the same. Be prepared for new banking rules, regulations, environment and relationships in the future.