VARIABLE RATE DEBT VS. FIXED RATE DEBT

By Patrick Niland

Is the Payoff Worth the Risk?

Just since the beginning of May, the U.S. Treasury market has dropped precipitously to levels not seen since the mid-1960s. New 25- and 30-year self-liquidating underlying mortgages now are available at rates under 7%, with 5- and 10-year balloon loans offered at even lower levels! This dramatic drop in interest rates has fueled a tremendous boom in refinancing for all types of loans. It seems that almost everyone I talk to either has just closed, or is about to close, a new loan. Some board treasurers, however, have held off refinancing their co-op's underlying mortgage, lured by the even-lower rates being offered on short-term adjustable-rate loans. Do they know something we don't? Should we take the bait as well? Absolutely not.

Too many board members forget that a co-op is a corporation just like General Motors, IBM, or Exxon. That means that a co-op board of directors is charged with exactly the same fiduciary duty as its commercial counterpart; namely, to maximize the value of its shares for the benefit of its owners (i.e., its shareholders). A board does this through (a) efficient management of the corporation's daily operations, (b) diligent care of the corporation's physical and financial assets, and (c) prudent manipulation of the corporation's capital structure. To ignore or short-change any of these important roles is a breach of shareholder trust.

Most boards delegate the supervision of their corporation's day-to-day activities to a team of professional managers under the guidance of the company's chairman, president, or other designated officer. Most cooperative apartment corporations hire a residential management company to collect maintenance, pay bills, oversee repairs, and handle most other aspects of their building's operation. The management company's building representative normally attends a monthly meeting and reports to the board members on each of these activities.

A corporation's chief financial officer is responsible for the organization's economic health and directs all of its financial affairs. A cooperative's financial well-being usually is monitored by the board treasurer and recorded by a professional accounting firm chosen by the board. This accounting firm audits the cooperative's books, issues annual financial statements, prepares tax deduction notices for the co-op's shareholders, and files the cooperative's corporate tax returns. Most of the co-op's liquid assets are deposited in insured bank accounts or invested in secure instruments like Treasury bills. Some cooperatives even retain the services of a professional money manager to maximize the return on their liquid assets.

Most large corporations have an internal staff which operates and maintains its facilities. Cooperatives usually outsource this work. A cooperative's physical plant should be monitored on a regular basis by its building agent. It also should be inspected thoroughly by a professional engineer at least every five years. Lastly, all cooperatives should execute a regular program of preventive maintenance to protect the physical integrity of their most important asset. Every co-op's annual budget should include a separate line item to cover the expected cost of these inspections and maintenance items.

But what about the cooperative's capital structure? How should this be managed to achieve maximum shareholder value? The overall goal should be to provide the funds necessary to operate and preserve the cooperative and its assets at the lowest possible cost, without exposing the corporation or its shareholders to undue risk. A cooperative's day-to-day expenditures should be covered by maintenance charges. As unpopular as it may be, co-op boards should increase maintenance <u>every</u> year to keep pace with inflation. Using reserve funds or credit lines to avoid a maintenance increase is a mistake that seriously undermines a cooperative's ability to weather unforeseen problems or pay for emergency repairs.

What about capital improvements and major repairs? How should they be funded? A time-tested rule of corporate finance suggests that "permanent" assets (like apartment buildings) and long-lived components (like a new roof or a boiler) should be funded with long-term debt. In simple terms, the maturity of the debt should approximate the expected useful life of the asset(s) being financed. Boards which finance their building or major capital improvements with credit lines or other variable-rate debt are violating this key principal and are gambling with their corporation's long-term financial health. They are, in effect, "betting the farm" on the direction of interest rates. Gambling is fine for a trip to Atlantic City or Las Vegas, but board members have no business playing such high-stakes games with their shareholders' major investment.

Despite all of the above, some board treasurers might argue that the savings from variable-rate debt become large enough over time to justify the interest rate risk. Their plan is to make a fast buck while rates are low before converting to long-term fixed rate debt when interest rates begin to rise. Conceptually, their strategy has some merit. Unfortunately, two "realities" are working against them.

First, the short end of the "yield curve" (i.e., the market for short-term interest rates) is extremely volatile – so much so that even professional money managers often are caught off-guard. It is important to remember that most board members are volunteers who wedge co-op business into off-hours and weekends. Moreover, very few of them manage money professionally. Therefore, more often than not, an inexperienced board finds itself trailing behind a rapidly rising interest rate market. By the time board members realize what has happened, agree on a new plan, call lenders, and close on a new fixed-rate mortgage, interest rates will have risen far above the level they could have locked in earlier.

The second "reality" is that most co-op boards are relatively poor at making fast decisions – especially when the decision involves a lot of money. We all know that board meetings are political arenas where multiple private agendas cloud the decision-making process. As a result, everyone – managing agents, contractors, mortgage brokers, even some lenders – wait for boards to make a decision. But the financial markets – which is where interest rates are determined – wait for no one. The odds of getting hurt by an adverse market move are substantial. Therefore, no co-op should allow its board to gamble with its financial future, regardless of the potential reward. If they guess right about the direction of interest rates, a few members of the board may be temporary heroes. However, if they guess wrong, <u>every</u> shareholder will pay the price for the life of the loan!

Board members have a serious fiduciary responsibility to shield their shareholders from significant risk. This important obligation should limit the uses of variable rate debt to truly short-term and/or emergency needs. No component of a cooperative's long-term or permanent asset base should be funded with variable rate debt. Just say "no"!