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What difference a "point" makes in the cost of debt

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Two weeks ago, buyers and we had a real time, real life, nail biting lesson on the fluctuation of debt cost around a real estate purchase. A group of investors were closing on an apartment complex, with about $4.5 million in equity contributions, and $9.2 million in federally backed debt. The debt was tied to treasuries, which we were scrutinizing on a daily and even hourly basis as we pushed towards the closing. Rates were favorable, but we were seeing fluctuations in the treasury rate of about 10 to 25 basis points, or up to a quarter of 1% interest cost. We wanted to lock a low rate soon.

As we labored through the typical closing hang-ups, we watched the low point of treasuries slip away over two days to a rate that was ultimately 20 basis points higher. We were finally at a point where we could lock the rate and decided to do so immediately, only to see the rate drop again, causing a lot of retrospective "woulda, coulda, shoulda".

The interest rate had increased off the low adding about $15,000 additional annual interest, a direct loss of NOI, which when capitalized equaled about $300,000 of unsupported principal. The lender showed no mercy. The amount of debt was quickly reduced by the $300,000, and the investors came out of pocket for the balance in the closing.

Fast forward to the National Debt Crisis. As of this afternoon, the Senate passed the House approved bill increasing and extending the national debt ceiling out to the year 2013, while allowing for a small amount of budget cuts. To put it in perspective, the budget cut was in the several billion dollar range, out of a $1.2 trillion budget deficit, although that small amount is not the point of the story. What is the point is that, while the new bill is a critical and important step forward, it may not be enough to preclude a down grading of U.S. Treasuries. Moodys is holding off for now, but is watching the U.S. carefully, particularly to see how Congress moves forward. If Treasuries are downgraded to AA from AAA, the interest rate attributed will have to increase in order to attract purchasers at the somewhat greater level of risk. No one knows what the rate would be, but let's hypothecate an increase of Â½%. In my apartment building example above, this increase would have cost $46,000 in lost NOI, with capped at 5% would have meant a $920,000 deduction in the available purchase debt. The math is straight forward; double it for 1%, etc., etc. While it would not be dollar-for-dollar, clearly this loss of purchasing power would have ramifications on value.

The total U.S. mortgage debt is at about $13.6 trillion currently. A Â½ point rise from the cost of that debt would be about $68 billion additional annual interest. The ramifications over the rest of the cost of the economy, (i.e. small business borrowing, consumer retail debt, etc.) would be huge as well, and this is all in relation to a meager Â½% increase. It is not a large stretch of the imagination to think it could be higher.

This is a very difficult moment in time. The U.S. Federal Reserve Bank, along with most other countries, will fight to keep interest rates low in order to preclude any more negative blows to our modest recovery. However, there will be inflationary pressures, and the need to attract money to treasuries at the new higher risk, should the downgrade occur. It is above my pay grade to opine on what will happen, but it is clear that there is still much risk. We have certainly been living in an artificially low interest rate environment. Some of us still remember the early 1980s, when president Jimmy Carter was fighting against inflation and interest rates, both topping 18%. That seems unfathomable now, where rates have hovered around 5% for years. But then again, we didn't have the debt problems then that we have now.

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