# Financing Options to Help Your Church Manage the Impact of Rising Interest Rates

By Rob Faulk, Partner

Interest rates on loans have risen significantly over the past two years. As a result, churches that are facing the need to refinance a loan, or that are considering obtaining loan financing for the first time, may be concerned about how to manage the cash flow impact of fluctuating interest rates.

Here are some financing options to consider.

**Multiple Notes with Different Interest Rate Characteristics**

Lenders often offer multiple rate-fix-duration options to choose from. For instance, the interest rate might be variable (adjustable on a monthly basis), annually adjustable, fixed for three years, fixed for five years, etc. One way to lower your interest expense is to divide the debt into multiple notes with different interest rate characteristics, thereby achieving a lower average or blended interest rate.

For example, an interest rate that varies monthly is typically lower than an interest rate that adjusts annually, and an interest rate that adjusts annually is typically lower than an interest rate that adjusts every three years. A five-year fixed interest rate would typically be higher yet. Consequently, if you choose to divide your debt into two notes, one with a three-year fixed rate and the other with a 10-year fixed rate, your average interest rate would be lower than if you were to place 100% of your principal balance on a 10-year fixed rate note.

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How many notes a church chooses to have may be a function of an interest rate risk management strategy, which may be unique to that church's circumstances. For example, let's assume a church plans to move to a new location, building a $10 million facility with an anticipated construction duration of 12 months. Following construction, the existing facility will be offered for sale at $2 million. The church plans to raise $3 million in pledges through a three-year capital pledge campaign.

Following construction, the $10 million debt may be divided into three notes. The church may choose to place $2 million of the debt into a note with an annually adjusted interest rate. That note could be paid off early via proceeds from the sale of the existing facility, thereby avoiding the risk of a higher rate as of the adjustment date. Another $3 million could be placed in a note with a three-year fixed rate. As pledges are received that second note could be retired early, thereby eliminating the risk of a higher interest rate as of the three-year adjustment date. The remaining $5 million could be placed on a note with a 10-year fixed rate.

In this example, the three different interest rate characteristics provide the lowest possible blended interest rate. If all goes as planned, there is no interest rate risk until year 10. To avoid cash-flow pressure, all three notes could be structured with 25-year amortization duration.

**Use an Interest Rate Swap to Secure a Longer-Term Fixed Rate**

Loans to religious institutions are of a specialized nature. Unlike home mortgages, the bank will typically not have access to a securitization market for church loans. Consequently, if a bank makes a fixed rate loan to a

church and halfway through the term of the loan interest rates begin to rise, the higher rates the bank must begin to pay to its depositors start to eat into the profit margin on the loan. The bank is forced to live with these circumstances. Therefore, a bank may be unwilling to fix the interest for more than three or five years without using an interest rate swap agreement.

A swap is a separate contract apart from the loan. It is an agreement between two counterparts to exchange payments that are based upon different interest rate characteristics. Simply stated, the swap essentially converts the underlying adjustable rate loan to a fixed rate loan. As a result, the borrower pays a fixed rate.

With a swap, it is important to understand what can happen if the borrower chooses to make prepayments against the loan, or refinance the loan entirely. Generally, if interest rates rise during the life of the loan, and if your church chooses to prepay the loan in part or in full, you may realize a gain (the bank pays you). Conversely, if interest rates stay the same or move lower, your church may realize a loss (you pay the bank). There is no exposure to a gain or a loss when the debt is simply serviced in accordance with the original amortization scheduled.

A swap is commonly designed to match your outstanding loan balance through the term of your loan. However, a swap is customizable to allow for prepayments without exposure to a gain or a loss. In the case of a 10-year swap, for example, if the church desires the latitude to prepay the loan in part or in full after year 5, or annually thereafter, a “cancellable” swap may be utilized. With a cancellable swap structured in this fashion, any prepayments made on the 5th, 6th, 7th, 8th, or 9th anniversary dates will not be subject to any gain or loss.

Alternatively, a swap may be structured to allow set amounts of prepayment at specific intervals, for example $100,000 every six months. Again, no gain or loss would be realized when these prepayments are made. If the prepayments are not made, that portion of the debt would simply revert to the underlying variable rate. Said another way, if the first two $100,000 prepayments are not made, thereafter the borrower would be paying a variable interest rate on $200,000 of the outstanding debt.

Finally, under some circumstances, swaps can effectively be transferred from one bank to another without incurring a gain or loss.

**Making a Prudent Decision**

Interest rate swaps are complex financial derivatives, and such an agreement can have significant implications for your church’s finances. Your church leadership should fully understand the implications of a swap before entering into such an agreement.

Churches should consult with knowledgeable legal and financial advisors before committing to an interest rate swap or multiple notes with different interest rate characteristics.

## About the Author

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