Global Church Solutions

INTEREST ONLY LOANS – RISK AND FORWARD PLANNING

Prior to the Global Financial Crisis (GFC) Banks and Lending institutions were offering loans to purchase and construct Church facilities on terms that seemed advantageous in a stable interest rate market and stable property market. Terms included a low percentage of equity being provided by the Church and a wide range of payment options including interest only for up to five years.

Many Churches took advantage of these "interest only" opportunities in the stable market conditions, enjoying the lower repayment amounts, based on assumptions such as

- the Church would grow numerically and financially before the principle and interest payments took effect
- the property market would continue to increase in value allowing a higher valuation of its equity at the end of the interest free period
- the lending institutions would refinance at the end of the interest only period, on similar terms

The new market conditions post GFC has seen that some of our Church assumptions have been proven to be incorrect. Many Churches have experienced a drop or levelling off of income with the property valuations in most major metro cities now showing a reduction not an increase in value. Financing criteria have tightened up with higher equity / debt ratios being required and increasing interest rates becoming part of our monthly news. The lenders to the Church markets are also changing their position asking for higher levels of financial reporting and greater interest cover calculations and/or greater debt servicing ratios, on a regular basis.

Tragically the outcome is that there are a number of Churches who cannot afford the increase in monthly repayments when the loan shifts from interest only to principle and interest. The result has been a mad scramble to reduce costs, reduction in staffing levels, and a "drive" for more giving. As an example of the impact of the difference, a Church with a $500,000 loan over 15 years at 7% with interest only for the first 3 years, the extra mortgage payment from year 4 shifts from $2917 per month to $ 5142 per month. That's $2225 extra per month. **NEARLY DOUBLE**

Are interest only loans a wise choice? There is a place for them as a means to Church financing even in today's post GFC environment. Providing there is a clear understanding of the risks and the Church Leadership builds a strong "forward looking" financial model recognising the impact of the future increased repayments from interest only to principal and interest.

Here are some practical processes we can put in place to avoid the financial stress and to minimise the Churches exposure.

1. An annual **budget system** that goes beyond next year to at least 5 years out
2. Acknowledgement that **interest rates could continue to rise**, so budget future interest costs at current rates plus 1%
3. A Board policy that the **Church finances will operate at a cash surplus** not deficit, hence we develop an operational mindset that decisions to spend more take into consideration the looming increase in repayments.

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4. A Board policy that **cash is set aside each year** and be a minimum 25% in Year 1 of the expected difference, 50% in Year 2 and 75% in Year 3. This means the Church is forced into operating on a "cash available" basis, so that when the increase occurs in Year 4 no adjustment is necessary and the Church builds a cash safety reserve available for the repayment of principle.

   Applying this to the example of the $500,000 loan above
   Year 1 $3473 Interest only $2917 plus voluntary saving $ 556 per month (25% of increase)
   Year 2 $4029 Interest only $2917 plus voluntary saving $1112 per month (50% of increase)
   Year 3 $4585 Interest only $2917 plus voluntary saving $1668 per month (75% of increase)
   Year 4 $5142 Interest and principle and accumulated savings in bank $40,032

As a result of a very practical approach when using this approach the Church manages its monthly expenses and cash better and the giant step when the principle repayment occurs is minimised in financial and in emotional terms.

As we learn from the past using hindsight let us apply wisdom to similar situations in the future to make our Churches stronger.

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