Liquidity costs

Insights

Mai 2023

For a long time, liquidity costs were not very important. In 2022, they have increased sharply in the market as a whole and are now also fluctuating strongly. There are large differences between the institutions, as the balance sheet and business strategy play a decisive role in the calculation of these costs. In the following, we explain the situation using examples from our practice and give advice on how real estate investors can deal with the increased liquidity costs.

Liquidity costs have risen sharply since the end of 2021. In the meantime, they can exceed the pure credit margin, e.g. for fund financing. In March and early April, for example, we observed cases where banks called for 80 bp (1 basis point (bp) = 0.01%) margin but 100 bp liquidity costs for ten-year financing, so that the total interest margin (spread between interest rate and swap rate, i.e. including credit margin and liquidity costs) ended up at 180 bp.

In the same period, other institutions were satisfied with significantly lower liquidity premiums, in some cases well below 50 bp. This resulted in total interest margins of between 80 and 180 bp with consistently competitive credit margins. In combination with the volatile swap rates, this resulted in total interest rates of 3.74% to 4.65% - a difference which, especially for longer maturities, could easily amount to several 100,000 euros in nominal credit costs and could even determine whether a purchase makes economic sense.

We present a simple indicator for the increase in liquidity costs for mortgage loans in the box at the end of the text. In practice, however, what is most interesting is how the individual institutions calculate in concrete terms. The big differences can be seen in four exemplary financings that were tendered via the credX platform:

- Purchase financing residential new build, > 30 m EUR FC volume for 10 years, interest margin 100 bp, LTV 80%, interest rate fixing with signing of term sheet
- Portfolio financing of local retailer purchase, > EUR 100 million FC for 10 years, LTV approx. 45%, credit margin 80 bp and liquidity costs 100 bp, thus interest margin 180 bp, interest rate fixing possible only shortly before disbursement.
- Acquisition financing for new local shopping centre, <10 m EUR FC volume for 5 years, LTV approx. 50%, interest margin 81 BP, reserved with submission of term sheet
- Portfolio financing care, < 10 m for 7 years, LTV approx. 50%, 111 bp interest margin, fixing with acceptance term sheet

For borrowers, this unfamiliar situation brings with it some special features:

- Compared to the years before 2022, loans have become much more expensive not only due to the sharp increase in deposits, but also due to liquidity costs
- The frequently practised comparison of "interest margins", i.e. the difference between the cost (usually determined via the swap curve) and the nominal interest rate offered, is not suitable for making a statement about the development of the actual bank margin. The impression that many banks have widened their margins is probably mostly due to this simplistic view.
- The liquidity costs applied by an institution are often more important for the conditions than the amount of the credit margin - especially since there is often little room for interest rate reductions in financing with low credit margins such as fund financing with moderate leverage.
- If a bank fixes the credit margin but not the cost of funds and the liquidity costs, the total interest rate can currently fluctuate by more than 50 bp in a few weeks.

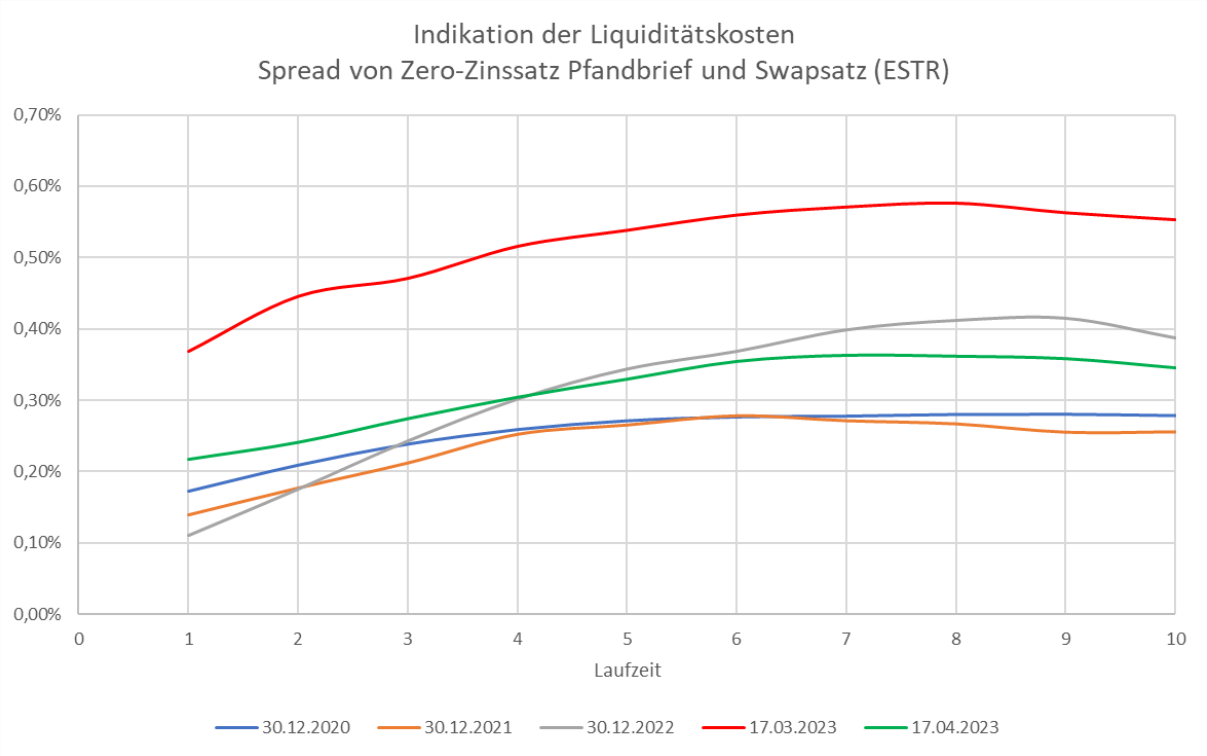
Borrowers are therefore increasingly interested in identifying those institutions that apply low liquidity costs and may also be willing to fix the interest margin or even the specific total interest rate at an early stage (by signing the term sheet or even submitting the indication). However, there is no reliable way to find this out via publicly accessible criteria. It is true that mortgage banks tend to be more capital market-oriented and pass on fluctuations in the money and capital markets quickly. But all institutions are already required by supervisory law to take liquidity costs realistically into account in their calculations. The mark-up results from several components that are not visible from the outside:

- The selected covered interest rate curve for the covered portion (usually 60% of the mortgage lending value)
- The selected uncovered yield curve for the remaining
- Premiums to reflect the risk of implicit options affecting the cash flow of the loan (e.g. earlier drawdown of funds or repayments)
- Costs of liquidity reserve creation
- Costs to meet the Net Stable Funding Ratio or to adequately price risks for meeting the ratio

The varying liquidity premiums are therefore dependent on a wide range of settings, the specific sources of liquidity available, the balance sheet structure, the rating of the institution and also business policy decisions. The premiums are made available to the account managers in the calculation systems on a daily basis. Depending on the business policy, the business managers can then make more or less adjustments to suit the specific case.

In our experience, the only way to achieve this is to make precise enquiries of the relevant institutions within the framework of a structured tender and, when evaluating the indications, to also specifically address the liquidity costs and the underlying deposit.

The spread between the Pfandbrief curve and the swap curve, which is shown in the following chart, provides an indicator of the direction of liquidity costs and, to a limited extent, how much they have changed:



Sources: Deutsche Bundesbank, Infront

The blue curve shows that the interest rates for Pfandbriefe were only slightly higher than the swap interest rates on 30.12.2020. This difference increased noticeably at the middle and long end as of 30.12.2022 (grey curve). For the 10-year maturity, it increased from 28 bp to 39 bp, and for the 5-year from 27 bp to 34 bp. Due to the tensions in the market as a result of the crises of American institutions and Credit Suisse, spreads rose very sharply in all maturities in mid-March (red curve). However, the green curve shows that the spread narrowed again very quickly in mid-April, so that it is now below the level at the end of 2022 again for maturities of 5 years and more. The course of the curves over time illustrates the high volatility currently observed in the refinancing market.

These ratios cannot be transferred 1:1 to uncovered funding, but they are suitable as an easily observable indicator in which direction and with what intensity the liquidity costs have changed. As explained above, each institution individually determines its liquidity costs against the background of its own specific funding sources and investment opportunities.