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The Impact of Rising Interest Rates on TCO

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Fleets using open-end leases may need to reevaluate their total cost of ownership (TCO) calculation as federal interest rates continue to rise in 2017, fleet management company experts told AutomotiveFleet.com.

The Federal Reserve has indicated it plans to increase its benchmark interest rate three times in 2017 by a quarter of a percentage point, which could impact the interest rate risk management strategies of fleet managers. Fleet managers may opt for a fixed rather than floating interest rate at the start of the lease term, the experts said.

"Merchants customers can choose a fixed-rate option at the start of each lease, thereby mitigating the short-term impact of rate increases to the overall TCO," said Jerry Pavelich, chief financial officer of Merchants Fleet Management. "Others can select the up-front benefits of lower cost variable rates with the understanding there could be offsetting higher costs if there is significant interest rate inflation over the long term."

The Federal Reserve is expected to raise its benchmark rate two more times in 2017, following its decision to increase the rate to a range between 0.75 and 1 percent on March 15. It was the third increase since the Great Depression.


Pavelich

Rising interest rates would affect fleets who use open-end as well as closed-end leases. In both cases, the interest rate locks at the onset of the lease. In a closed-end lease, the cost of interest isn't transparent.

The impact to TCO may be minimal, and companies should use interest rates as just one factor in a broad-based financial risk management strategy, said Gernot Leinenbach, group chief financial officer and senior vice president of finance for ARI.


Leinenbach

"In our view, the goal should be to develop a consistent budgetary forecast and a reliable replacement model that supports adequate working capital and their cash flow needs, while meeting practical requirements of the fleet in the most efficient manner possible," said Leinenbach. "Economic trends and the interest rate environment are a part of the equation, but they, in most cases, should not be the sole determining factor in making decisions about when to lease."

There can be another strategy for reducing the impact of higher interest costs that allows a fleet manager greater flexibility with what's known as the amortization or reserve rate, said Norman Din, vice president of strategic sales with Wheels, Inc.

Fleet managers who choose an open-end lease can allocate additional principal each month to pay down the existing balance. By increasing the payment, and increasing the amortization rate, the fleet manager can reduce the outstanding balance that's being financed, and lower the increased interest rate cost over the life of the vehicle, Din said.

"Since amortization payments reduce book value of the vehicle, the larger payments simply reduce what's owed on the vehicle – like increasing your principal in a monthly mortgage payment," Din said. "It's still your money and is used to offset what's owed at the end of the lease."


Din

Fleet managers considering these strategies should always check with their company chief financial officer or treasury department before taking action, the experts said.

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