WHAT DOES MONEY CO$T?

by Harold Montgomery

It's hard to think of money costing money, but it does. Even when you go to the ATM to access your own cash, the bank charges you for that. Why? Well, the ATM costs something, the bank costs something, the ISO gets a little bit, etc. I bet I don't have to explain that to readers of this magazine who are in the money moving business!

The cost of capital is central to finance. The Ultimate Bank, the Federal Reserve Bank of the United States, charges its fed funds lending rate to other banks when they need money to fund deposits or loans. These banks then charge their borrowing customers a higher number and keep the difference. Sometimes those borrowers turn around and lend out that money at a still higher rate. So, for example, the Fed lends Citicorp $1 billion at around 5% and lends MBNA $1 billion at, say, 8% and then MBNA lends out the $1 billion to its consumer customers at 18% - something like that. (I made this example up, but you get the idea.)

You might think MBNA is making all the money here, and they are netting a lot, but they also have the highest costs of administration and bad debt. Some of what they lend will not be paid back at all, and the rest will come back in an unpredictable time frame, making their task of matching maturity dates of their loans and debt a headache. While Citicorp has one loan to monitor, MBNA could have 100,000, each one of which has to be monitored monthly. Customer service calls, statements, write offs – it all adds up. Citicorp can be pretty sure that their loan to MBNA won't go bad, but MBNA has to worry about 100,000 individual consumers whose credit status is constantly changing.

And therein lies the point: The cost of capital is different for different people or entities. The small consumer may be paying 18% but he is also glad to have access to the $10,000 line of credit. Each one of those consumers depends on the others. They only make sense as loans collectively. The costs of administering a single $10,000 loan are prohibitive. The only way it works is if there are 100,000 of them to aggregate together. The ones which are good pay for the ones which go bad and all that overhead to keep up with the whole package.

Furthermore, the consumer needs his money now, which brings up the time value of money – a dollar you have today is worth more than a dollar you will get tomorrow. How much more? The same as your cost of capital plus the risk premium you associate with the use of the funds. For example, would you rather have $100 now or $1,000 later? That depends on when the $1,000 is coming and what is going to happen between now and then. What about inflation? What about risks like war? Are we talking about one year from now or 100? If the $1,000 is coming to me 20 years from now, I think I will take the $100 now.

The longer I have to wait for my money the more risk there is. Those risks are derived from a variety of sources, some mentioned above. In any case, I want an enhanced return for that money to compensate for the perceived risks over time. Notice I said perceived risks – not necessarily the real ones, just the ones I can perceive.

All of these factors combine to create a cost of money, or the present value of a future amount of money like the mythical $1,000 above. That $1,000 discounted for risks and costs has an equivalent amount in current dollars – a current twin amount that you would theoretically be indifferent to having.

Take the $100 now or $1,000 later puzzle. If you only had to do nothing and wait one day for the $1,000, then the choice is obvious - take the $1,000. If you have to wait 20 years and inflation is 100% per year, the choice is equally obvious – take the $100 now. Somewhere between those absurd extremes, there are many combinations of factors which make the two choices equivalent. One such point is this: $100 now or $1,000 in ten years with an inflation rate of 5%, a cost of capital of 12% and a perceived risk compensation of 8% per year – a total discount rate of 25%. (These numbers don't reflect current business conditions, they're just theoretical. But these numbers would have been from real life circa 1990.) These two choices are roughly equivalent – that means the present value of the transaction is zero – take either one and the payoff is the same.

This kind of thinking is useful when you are evaluating your business plans and the expected payoffs they contain. How long are you willing to wait for your reward vs. how much is it worth right now? ■

Harold Montgomery is the CEO of Calpian, Inc., an ISO in Dallas, Texas, providing financing opportunities to all levels of merchant acquirers. You can contact Harold at 800.589.1173 or portfolio@calpian.com.