

DebtBook's Approach to the Incremental Borrowing Rate

PRIOR TO SEPTEMBER 30, 2022

For those who don't want to go to your banker for a separate rate every time you enter into a new lease, we wanted to build a simple yet powerful template to estimate your incremental borrowing rate.

As you read ahead, there are a couple things to keep in mind:

- We are not trying to calculate the exact rate you would have been charged. The goal of the exercise is to have a reasonable basis for developing an accurate estimate of what your interest rate would have been.
- Instead of assuming each loan would be secured by the underlying asset (which would require you to calculate multiple incremental borrowing rates across multiple asset classes), we assume you would use your lowest interest rate financing vehicle (typically a general obligation or general revenue bond) to purchase the asset. This approach simplifies the process and reduces the information you need to gather. For more details on this assumption, [click here](#).
- We want the framework for calculating your incremental borrowing rate to be simple, practical, and repeatable, as you'll need to recalculate your incremental borrowing rate periodically moving forward.

With these basic assumptions, DebtBook has created a simple Excel template to calculate your incremental borrowing rate using the same interest rate formula outlined above:

$$(\text{Bank's Cost of Funds}) + (\text{Credit Spread}) = \text{Incremental Borrowing Rate}$$

We assume the bank's cost of funds will match the United States Treasury Yield Curve, which is the most commonly quoted and readily available index for determining cost of funds. Note this isn't perfect, as each bank may use different indices or a combination of indices and other factors to calculate their own subjective cost of funds, but we believe the United States Treasury Yield Curve provides a reasonable proxy across a wide variety of circumstances and markets.

DebtBook then asked several commercial banks to provide generic credit spreads above the applicable US Treasury yield that they would reasonably expect to charge public sector borrowers based on their rating category and the term of the loan. We averaged the responses to come up with our own generic credit spreads used in the template. We will periodically update the template's credit spreads, if necessary, but remember our goal is to provide a reasonable basis for estimating your incremental borrowing rate, not to derive the exact rate for each and every lease.

Here's an example. If your "AA"-rated municipality entered into a lease commencing on September 1, 2020 for a term of 36 months, we would use the three-year United States Treasury Rate as of September 1, 2020 to estimate your cost of funds and then add the average credit spread provided to us for a 36-month, AA-rated loan.

So, if the three-year US Treasury on September 1, 2020 was 0.14% and the average credit spread for a three-year, AA-rated loan was 1.10%, then we can estimate your incremental borrowing rate to be 1.24% using the simple formula below:

$$0.14\% + 1.10\% = 1.24\%$$

Note the calculation above assumes a taxable financing. In our template, you can make simple adjustments to account for a lower tax-exempt rate, if appropriate for your circumstances.