CHOPPING UP YIELD MAINTENANCE

by Steve Brown

An expert chef can chop 6 carrots in less than 10 seconds. We bring this to your attention because to make a good pot of stew, one must chop a lot of vegetables. Much the same can be said when it comes to client loan negotiations. For many, this process requires the bank to parse apart various components of the loan agreement, to help the client understand what they will be signing. Some bankers tell us their clients put a particular focus on any yield maintenance ("YM") provisions in such documents. Therefore, in an effort to raise awareness, increase understanding and give lenders an opportunity to add this component to their client negotiation repertoire, we chop up a sample YM provision found in many national bank loan documents. Recall that banks should insert this wording into long-term fixed rate loans whenever possible, in order to provide protection to the bank against prepayment. Provision wording is in italics, while comments follow. "In order to establish the Fixed Rate, it may be necessary or advisable for Bank to "hedge" an amount equal to the principal amount of this Note in the financial market or to otherwise make arrangements or take actions to permit Bank to carry out its obligations hereunder, which actions may result in various costs and risks to Bank beyond those Bank would otherwise incur with respect hereto." This section basically informs the customer that the bank extending them the loan may also end up hedging that loan, and that doing so may cause it to incur an additional cost. "Accordingly, if Borrower prepays all or any portion (in minimum increments of $100,000) of this Note," The bank will allow the customer to prepay, but payoffs must be in minimum increments of $100k (this allows the bank to unwind portions of its hedge at reasonable market rates). "or if this Note shall become due and payable at any time prior to the Fixed Rate Maturity Date by acceleration or otherwise," This is legal mumbo jumbo indicating that any payoff of the loan for any reason prior to maturity shall trigger the provision. "Borrower shall pay to Bank, or Bank shall pay to Borrower, immediately upon demand a feeÂ..." This is important, as it indicates the bank may also be on the hook to make a payment to the borrower, depending on the interest rate environment at time of payoff. "Â...which is the sum of the discounted monthly differences for each month, from the month of prepayment through the month in which the Fixed Rate Maturity Date occursÂ..." This tells the borrower how the payment would be calculated at the time of payoff. Banks should discuss with clients what happens when they originate a fixed rate loan (i.e. the money is tied up until maturity and cannot be lent to anyone else, even if rates rise in the future) and then provide sample calculations (we can help with this). Customers have an easier time understanding this piece when they can calculate the payoff payment at any time and gain a better understanding that prepaying early (when interest rates have fallen) causes the bank to lose the remaining coupons it would have received through the loan's maturity (so a payment will be due from the client). Conversely, if rates have risen, the bank will make a payment to the client (i.e. they can now make a loan at a higher rate). Because of this equality, YM is economically better for the client than most other prepayment penalty structures. As such, the bank will make a payment to the client if the loan is prepaid when rates have risen. In the end, banks that can explain how to calculate the YM provision to customers are better positioned than those who cannot. After all, if you were a customer, would you rather pay a 3% penalty declining, or have the potential to pay the loan off at the time of your choosing and pay nothing (or even get a "thank-you" check from your bank)? Please let us know if you would like a copy of a real yield maintenance provision or want any help chopping it up.

BANK NEWS

Acquisition

BB&T Corp ($116B, NC) will acquire First Citizens ($483mm, TN) in a transaction valued at nearly $142.89mm or 3.8x book.

Acquisition

Shearson Home Loans will acquire mortgage broker Allstate Funding in a transaction valued at nearly $5mm. The combined entity is estimated to have annual loan volume in excess of $1B annually and a strong regional banking presence on the West Coast.

Branch Acquisition

Mid Penn Bancorp ($457mm, PA) will acquire 2 local branches of Omega Bank ($1.9B, PA) for an undisclosed sum. The deal includes nearly $32mm in deposits and $28mm in loans.

Growth Plans

Orrstown Bank ($760mm, PA) will acquire a local branch of Omega Bank ($1.9B, PA) for an undisclosed sum. The branch will include nearly $5.6mm in deposits and $3.6mm in loans.

Possible Sale

TD Banknorth ($40.3B, ME) has said that it plans to pursue an aggressive growth strategy during the next 2Y and hopes to double in size. The Canadian-backed company will focus on growth and pursue acquisitions in the mid-Atlantic, specifically NJ, NY and CT.