



Demystifying Yield Maintenance

hedging business customers

Summary: Yield maintenance can be confusing. But, it doesn't have to be. We walk you through it.

Experts say homeowners should set aside 1% to 3% of a home's purchase price every year in a savings account to plan for ongoing or unexpected maintenance or repair costs. Also, the older the house, the more the homeowner should set aside.

In banking, maintenance and savings of all types are topics that are clearly understood. One type of prepayment structure known as yield maintenance, however, can sometimes be confusing. Unlike a fixed prepayment penalty such as 1% (times the loan balance at time of prepayment), yield maintenance is different. It is structured so the lender "maintains" the same yield on the loan that is being prepaid "as if" it remained in place, and the borrower made all scheduled payments originally agreed to under the note through its maturity date.

To understand yield maintenance even better, let's walk through a scenario. Your bank issues a loan at a fixed rate of interest, and expects principal and interest payments on that loan through a projected maturity or payoff date. Your lending team models each loan to determine a projected rate of return and align borrower expected payments with funding needs. Borrowers get consistency to help them budget and plan with the fixed rate loan structure, and your bank receives a consistent income stream from the loan payments.

In some situations, however, a borrower pays off the loan early. When they do, rates can be higher or they can be lower than when the loan was originated. When current interest rates are lower than that of the loan, the prepayment suddenly reduces the rate of return the bank had expected. Also, the unexpected prepayment means the bank is very likely at risk of losing its customer, as they refinance or payoff the loan and go elsewhere.

As a prepayment structure, yield maintenance benefits both the bank and the commercial borrower. It does this because it serves to mathematically calculate the point of indifference for both parties, if the borrower wishes to prepay a fixed rate loan at any time in the future following origination.

This flexibility and calculated indifference to both borrower and lender can be crucial because yields can be very volatile, and borrower conditions, needs and opportunities change over time. This year alone, for example, the 10Y high quality corporate debt issuance yield (serves as a basis for many longer term loan structures) has swung 35% between low and high levels YTD.

In addition to the prepayment structure of a given loan, the market yield structure matters too. Here, we find that the yield curve is very flat. That means borrowers want to lock in longer on their loans and they are not incentivized to prepay. Even as rates perhaps drop from here, yield maintenance ensures the borrower is indifferent to any interest savings they might receive; that is offset by the yield maintenance prepayment fee they would owe the bank. In the alternative, if rates went up, the cost of the higher rate is offset by the yield maintenance prepayment fee the borrower would receive.

Yield maintenance doesn't have to be complicated. For more detailed information on this subject, watch for another article coming soon. In the meantime, [click here for more information](#) or contact our team of hedging experts for assistance.

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