



## Demystifying Yield Maintenance

by [Steve Brown](#) Topics: [hedging](#), [interest rate swap](#), [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.

# ECONOMY & RATES

Rates As Of: 07/01/2019 09:57AM (PDT)

Treasury	Yields	MTD Chg	YTD Chg
3M	2.12	0.03	-0.24
6M	2.10	0.01	-0.38
1Y	1.94	0.02	-0.65
2Y	1.80	0.04	-0.69
5Y	1.81	0.04	-0.71
10Y	2.04	0.04	-0.64
30Y	2.57	0.04	-0.45
FF Market	FF Target	Fed Disc	
2.40	2.50	3.00	
SOFR	Prime	Unemp	
2.50	5.50	3.60	

[More Market Rates](#)

## BANK NEWS

### Digital and Branch

[ING research finds](#) 59% of Americans use an app for banking information, while 61% use a website. Yet, 70% of Americans still sometimes decide to physically visit their bank branch to access financial services, and perhaps unexpectedly, across the total survey sample, the results are consistent across ages.

### CMBS Delinquency

In May, [the Trepp CMBS Delinquency](#) Rate fell to 2.66% (falling 16bp) for a new post-crisis low. A greater number of troubled loans were pushed out of the system, while new CMBS issuance stayed steady.

### Spillover Risk

Assets held by global shadow banks have reached \$52T, soaring to a 75% increase above 2010 when the financial crisis ended. The largest areas of growth have been in what are known as "collective investment vehicles" (bond funds, hedge funds, money markets and mixed funds). Bank regulators remain worried about the possibility of spillover risk for the banking system from this largely unregulated area, if stresses appear.

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