Comparing Yield Maintenance with Modified Yield Maintenance Prepayment Penalties

Yield Maintenance prepayment arrangements usually make it possible to offer a lower rate. Lender prefers to have Borrower keep the loan to term and make all the payments, without the threat of having the payment stream (investment yield) interrupted by early pay-off.

Since in the real world early pay-offs do happen, a provision for it is made. Borrower is welcome to pay off early as long as in addition to the remaining principal, he/she pays an additional amount so that the Lender's yield (return) is the same as if he/she has kept the loan to term. This additional amount is calculated the day prior to payoff, and is calculated (using a proprietary formula) by comparing market rates (interest rate index used for the subject loan) as of that pay-off day with that as of the day of funding. If rates are declining, this additional amount is high. If rates stay the same, the additional amount will still be high, though less so than if rates were declining. If rates are increasing, the additional amount will be less (maybe much less; could be $0.00), though there is usually a minimum additional amount (prepayment penalty) of 1.00% of the amount of the loan. The actual amount of the prepayment penalty is calculated the day before the actual payoff. Since the calculation is based on the rates at that time, there is no way to predict the dollar amount of the prepayment penalty in advance, such as at the time the loan is being negotiated. This type of prepayment penalty is best suited to borrowers who are likely to keep the property and the loan for the duration of the fixed-rate term. The final three-six months of the fixed rate term is with no prepayment penalty at all, so that the borrower has opportunity to make arrangements to pay off just before the fixed rate loan term.

The prepayment penalty that comes with the loan specified for the loan we are discussing (Loan # 1800) is Modified Yield Maintenance, which is a variation of standard garden variety Yield Maintenance described above. With Modified, if rates are going up the prepayment penalty (that additional amount) will decline. In fact, it can decline to $0.00, and there is no 1.00% minimum; Borrowers would pay no prepayment penalty at all. Further, the index rate at early pay-off time can rise high enough that the prepayment penalty can be less than $0.00 which means that it becomes a negative prepayment penalty. A negative prepayment penalty results in Lender paying Borrower when Borrower pays off early; Borrower receives a check from Lender if the loan is prepaid. This actually happens.

Since the industry feels that rates will rise over the next few years, Modified Yield Maintenance is thought to be a favorable prepayment penalty arrangement for both Borrower and Lender. The scientific name for it is swap-based prepayment penalty calculation. Just prior to funding, Borrower will be required to participate in a telephone seminar on the subject of the workings of this in layperson's language. Its purpose will be to further acquaint the Borrower with this feature, though he/she may never use it.

This swap-based pricing with modified yield maintenance is relatively new in the small loan market. It makes possible lower interest rate pricing in situations where the prepayment penalty is acceptable to the borrower. A rising-rate environment would bode well for a loan with this type of prepayment penalty. As well, it the borrower is one who is keeping the property and is not inclined to refinance regularly, this loan is a good choice.