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FINANCE AND BANKING ALERT

IN THIS ISSUE

BREAKAGE COSTS – FINANCIAL IMPLICATIONS OF THE "MARGIN"?

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Breakage costs arise as a result of the lender having to redeploy its underlying borrowings as a result of the early prepayment by the borrower, as there is a risk that the amount which the lender receives on prepayment may be less than the amount which the lender is obliged to pay on that sum it borrowed in the interbank market.

Breakage costs arise as a result of the lender having to redeploy its underlying borrowings as a result of the early prepayment by the borrower, as there is a risk that the amount which the lender receives on prepayment may be less than the amount which the lender is obliged to pay on that sum it borrowed in the interbank market. This may be the case even if the lender invests the amount received as an early prepayment. The lender passes this risk on to the borrower so that it will never be on the losing end.

Interest rates usually comprise of two elements:

- a base interest rate, which may be a fixed or variable rate and if it is a variable rate, it is usually JIBAR plus; and
- a margin, which is the rate charged by the lender. The margin is the profit that a lender charges for availing the loan to the borrower and taking the risk of non-repayment.

There are different definitions of breakage costs or break costs in the market. The Loan Market Association documents contain the following definition of Breakage Costs in relation to a variable interest rate loan:

“Breakage Costs” means the amount (if any) by which:

(a) the interest which a Lender should have received for the period from the date of receipt of all or any part of its participation in a Loan or Unpaid Sum to the last day of the current Interest Period in respect of that Loan or Unpaid Sum, had the principal amount or Unpaid Sum received been paid on the last day of that Interest Period;

exceeds:

(b) the amount which that Lender would be able to obtain by placing an amount equal to the principal amount or Unpaid Sum received by it on deposit with a leading bank in the Relevant/Johannesburg Interbank Market for a period starting on the Business Day following receipt or recovery and ending on the last day of the current Interest Period.

The above standard definition covers the total interest (base interest rate plus the margin) which the lender would have received had the prepayment not occurred, and compares that with the interest which can be earned on the payments received (usually JIBAR). The margin, included therein, compensates the lender for the risk of non-repayment

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The standard definition is problematic because the margin applies whether or not the borrower repays the loan, that is, whether or not the risk of non-repayment exists.

of the loan. The standard definition is problematic because the margin applies whether or not the borrower repays the loan, that is, whether or not the risk of non-repayment exists. It is also important to note that breakage costs will not apply to fixed rate loans or prime rate loans.

The financial implication of including the margin versus excluding the margin is best understood by way of an example: A loan of R100,000 is made at an interest rate of three months' JIBAR plus a margin of 2%. The loan is repayable on the 90th day thereafter, the interest period is 90 days and the relevant interest period commences on 1 January 2017 and ends on 31 March 2017. On 1 January 2017, when the three months' JIBAR is set for the interest period, it is 5%. The borrower gives the lender notice that it wishes to prepay and settle the entire loan on 31 January 2017. On 1 February 2017 (the date on which the lender will reinvest the prepaid amount), three months' JIBAR is 4%.

The following table calculates the breakage costs with the margin, and breakage costs without the margin:

Breakage costs including the margin	Breakage costs excluding the margin
Daily interest on the full loan amount: R100 000 x 7% (JIBAR 5% + margin 2%)/365 = R19 per day Loss of interest for 60 days as the loan is repaid on day 31 (1 February 2017 to 31 March 2017): R19 x 60 days = R1 140	Daily interest on the full loan amount: R100 000 x 5% (JIBAR 5%)/365 = R14 per day Loss of interest for 60 days as the loan is repaid on day 31 (1 February 2017 to 31 March 2017): R14 x 60 days = R840
JIBAR on 1 February 2017 (date of reinvestment) is 4%: R100 000 x 4% (JIBAR 4%)/365 = R11 per day Interest for 60 days (1 February 2017 to 31 March 2017): R11 x 60 days = R660	JIBAR on 1 February 2017 (date of reinvestment) is 4%: R100 000 x 4% (JIBAR 4%)/365 = R11 per day Interest for 60 days (1 February 2017 to 31 March 2017): R11 x 60 days = R660
Breakage costs payable: **R1 140 – R660 = R480**	**Breakage costs payable:** **R840 – R660 = R180**
Difference: R300	

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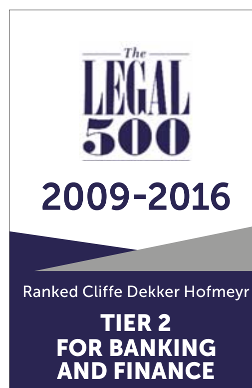
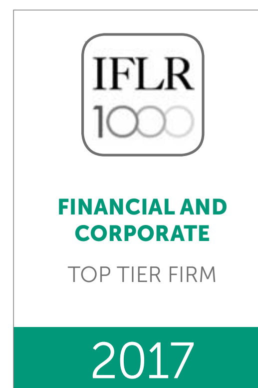
CONTINUED

From a borrower's perspective, paragraph (a) of the standard definition of Breakage Costs should always be amended to read: "the interest (excluding the Margin)", as this could save the borrower a substantial amount of money.

A prepayment of the loan by the borrower removes the risk that the margin seeks to compensate the lender for, namely, the risk of non-repayment. It is submitted that in these circumstances the margin is not justified. Accordingly, from a borrower's perspective, paragraph (a) of the standard definition of Breakage Costs should always be amended to read: "the interest (excluding the Margin)", as this could save the borrower a substantial amount of money in the event that the borrower decides to make a prepayment to the lender on a date other than an interest payment or repayment date.

Preshan Singh-Dhulam





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