What are Economic Costs?

When you take out a Tailored Business Loan a (**TBL**) with us we offer you a choice of different floating rate, fixed rate and hybrid rate products designed to help you manage your financial risk.

Just like any other business we also need to manage our financial risk. We need to be certain that we are able to provide you (and our other clients) with the amount of loan for the period you require at the interest rate calculated in accordance with the terms of the relevant product. In order to do so, we enter into various arrangements and agreements both specifically in connection with your loan and in relation to our business more generally.

We enter into these arrangements and agreements on the assumption that we will make funds available to you and that you will pay interest and repay capital to us in accordance with the timetable set out in your TBL. We therefore agree with third parties that they will make funds available to us on particular days in order that we can lend those funds to you and we agree to make payments to third parties on particular days on the basis that we will be receiving payments from you on those days.

If you vary the timing or amount of the payments that you receive from us, or pay to us, under your TBL we must:

- vary or terminate the agreements and arrangements that we have put in place with third parties, or
- put funds which we have obtained from third parties and which you no longer require to an alternative use, or
- find funds from an alternative source (to replace funds that we had anticipated that we would receive from you) to enable us to make scheduled payments to third parties.

In doing any of these things, we may incur a cost.

We call these costs "Economic Costs". It is important to realise that Economic Costs are brought about by you changing the terms of your agreement with us. This is why we pass on these costs to you.

Please note that these Economic Costs could be substantial and therefore you must seek independent financial advice before entering into a TBL.

When do Economic Costs occur?

Economic Costs may occur for a variety of reasons. For example:

- You want to repay the whole or part of a loan early, perhaps because you have generated more profits than you expected, you sell part or the whole of your business or you can obtain better rates with a different type of loan.
- You breach the terms and obligations of the TBL documentation and we require you to repay the loan or part of it early.
- You are having cashflow problems and want to delay payment of part of the capital that you agreed to repay.
- You fail to drawdown the full amount that you agree to drawdown on the date that you agreed to draw it.
- You no longer require the loan and cancel the loan facility other than if this cancellation is provided for in the TBL already.

In each of the above examples the underlying tenet is that the cashflows agreed at the outset are being altered.

How are Economic Costs calculated?

Economic Costs are calculated on the basis of the change in cashflows to us as a result of any alteration to or cancellation of a TBL. Taking the Fixed Rate TBL as an example, in calculating the Economic Cost on a Fixed Rate TBL, we would calculate today's value of the outstanding interest payable by you at the rate agreed under the Fixed Rate TBL Offer Letter.

We would then calculate today's value of interest that could be earned by us if we were to reinvest the funds for the remaining period of time, ie from the time you have requested to break the facility to the original expiry date agreed to in the Fixed Rate TBL Offer Letter. The rate of this calculation is based on the market rate for the remaining term of your facility on the day you have requested to break the original facility.

The difference between these two values then determines whether there is an Economic Cost or benefit to you from breaking this facility. If the value of interest which could have been earned by the bank for the remaining period of your facility is less than the value of the interest owed by you under the agreement then you will pay us an Economic Cost. If the opposite is true, then we will pay you an economic benefit.

Example

You have borrowed £1million through a Fixed Rate TBL for a term of ten years. The loan will amortise in full over this period in time. The fixed rate you are locked in at is 5.25%. In three years time you approach us to redeem the facility. At that time, the interest rate we are able to earn for the remaining seven years left on the facility is 4.25% as the rates have fallen by 1%. In this example you would be required to pay to us an Economic Cost of £27,950 which represents the present value of the difference between your contracted obligation to us at 5.25% and what we can now earn at 4.25% for the remainder of the term of the facility (ie seven years).

What factors may impact on the amount of Economic Costs payable?

All the following are relevant:

- the amount of the loan;
- the unexpired term; and
- long term and short term interest rates on the date the Economic Costs are calculated compared to the interest rate environment on the date you entered into the transaction.

Bearing in mind all of the above in certain circumstances Economic Costs may be substantial.

What should you do if you are worried about having to pay Economic Costs?

Payment of economic costs is a contractual obligation. You need to consider economic costs when choosing a TBL product.

If you have any doubts about whether a particular TBL is suitable for you, or you need advice about the future movements of interest rates, you should consult your independent financial adviser or accountant.

For further information on Economic Costs please contact your Risk Management Services Representative.