Make-Whole Call Provisions
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What is a Make-Whole Call?
A make-whole call is a type of call provision in a bond allowing the borrower to pay off remaining debt early. The borrower has to make a lump sum payment to the holder derived from an earlier agreed-upon formula based on the net present value (NPV) of future coupon payments not paid because of the call.

How is a Make Whole Call Different from a Regular Call Feature?
A typical call option enables the issuer to benefit by prepaying the debt when market yields decline. In a declining interest rate environment, the settlement amount of a typical call option is less than what the fair value of the debt would have been absent the call option. In contrast, a make-whole provision involves settlement typically determined by discounting the debt’s remaining contractual cash flows at a specified small spread over an appropriate Treasury rate.

Advantages of a Make-Whole Call:
- Investors may be compensated, or made whole “usually by an amount significantly above the debt’s current fair value based on the issuer’s current spread over the current Treasury rate. The make-whole provision contains a premium settlement amount to penalize the debtor for prepaying the debt and to compensate the investor (i.e. attempt to make the investor “whole”) for its being forced to recognize a taxable gain upon the early settlement of the bond.

What Would Happen if the Make-Whole Call Were Invoked?
An example may include the following:

- An investor purchases a bond from Company A under a 3-year maturity with fixed semiannual coupon payments. The agreed upon spread over the US Treasury at issuance is 100 basis points (bps) (1.00% over a comparable US Treasury). The loan agreement contains a make-whole provision that if Company A prepays the debt, it will pay the investor an amount equal to all the future semiannual cash flows discounted at the current Treasury rate plus 25 basis points.

- At a spread of +25bps, the yield is much lower (and price much higher) than the previous fair market value of +100bps. In the less frequent case where a bond’s fair market value spread is less than the make-whole call spread (i.e. fair market spread is less than 25 bps), the holder will be made whole at a price of par ($100)- still a price higher than you would have received at the previous fair market value.

Disadvantages of a Make-Whole Call:
- Because the cost to the issuer can often be significant, such provisions are rarely invoked.
- The provision can be utilized at any time.
- If invoked, the bondholder is subject to receive a lump sum payment earlier than anticipated.

Summary:
A make-whole call provision should be treated differently from a traditional bond call feature and could be considered as an attractive additional attribute of a bond. The inclusion of the make whole call provision is becoming more common. Approximately 20% of the issues in the Merrill Lynch 1-5 Year Government/Corporate Index have make-whole call provisions.

If the provision is invoked, the holder typically receives an amount significantly above the debt’s current fair value. However, since a make-whole call payment may force the holder to realize a gain and receive a lump sum earlier than anticipated, some investors may consider their own accounting needs before approving the use of such bonds.