Hedging Your Risks: Loan Level Interest Rate Cap Protection

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What is an Interest Rate Cap Agreement and What Drives the Need for this Protection?

An interest rate cap agreement ("Rate Cap") is a form of interest rate movement protection for a floating rate loan. A Rate Cap is entered into by a borrower, as cap purchaser, and a third party, as cap provider, pursuant to which the cap purchaser will pay a one-time, upfront premium and in return, the cap provider will make payments to the cap purchaser in the event the interest rate on the floating rate loan exceeds a set strike rate. The payments from the cap provider will typically be based on the principal balance of the loan. Market participants entering into floating rate loans commonly utilize a Rate Cap to provide protection from increases in short-term interest rates. Commercial mortgage-backed securities (CMBS) lenders often require a Rate Cap as a condition to making a floating rate loan. A Rate Cap serves as protection against the risk that a special purpose bankruptcy remote borrower may not have sufficient cash flow to make higher interest payments on the loan in a high interest rate environment. Although Rate Caps can protect against term defaults, it is important to note that they in no way protect against refinance risk if rates have moved up.

Each period, the payment (if any) from the cap provider to the borrower is determined by comparing the actual level of the underlying index (such as LIBOR) with the cap rate. If the index rate exceeds the cap rate, the payment is based upon the difference between the two rates, the length of the period, and the contract's notional amount. Using LIBOR:

Cap Payment = (index rate – cap rate) * (actual days / 360) * (notional amount)

In order to illustrate the protection a Rate Cap is able to provide on a floating rate loan, Chart 1 demonstrates a hypothetical sample of a Rate Cap set at a strike rate of 5.0%.

How is a Rate Cap Priced?

A Rate Cap can be thought of as a series of interest rate options called caplets. Consider a floating rate loan with monthly payments and monthly index rate observations; a Rate Cap with a 5-year term would consist of 60 caplets. Each caplet would be a month in term and observe 30-day LIBOR, typically at the beginning of the period. Interest rate caps are priced by valuing the individual caplets and summing the values. Caplet values are also used for FAS133 reporting purposes.

There are primarily two components in calculating the Rate Cap premium: the absolute level of interest rates determined by the forward yield curve ("delta") and option volatility ("vega"). Chart 2 shows the relationship between Rate Cap premiums to delta and vega for caps struck at 300 basis points over 30-day LIBOR during the last fifteen years. As demonstrated in the data, fluctuations in interest rates are not necessary correlated positively with Rate Cap prices.

How is a Rate Cap Purchased?

Most large commercial banks and investment banks have entities that issue Rate Caps and other derivatives. Given the upfront cash premium requirement, issuers typically are comfortable offering Rate Caps to borrowers provided that the borrower meets certain industry-defined conditions and bank-specific credit requirements. Assuming these conditions are satisfied, borrowers either contact the issuer directly or work through an advisor to procure the Rate Cap.

Surprisingly, cap pricing can range widely across issuers, depending on the individual bank's cost structure and their trading desk's view of delta and vega. As such, competitive auctions are often employed for purchasing Rate Caps. In addition, rating agency-assigned ratings vary across issuers, therefore the rating requirement of the issuer for a particular transaction can also impact the price.

In situations where a Rate Cap is required, such as a CMBS transaction, the Rate Cap is often required in connection with the pending securitization. Therefore, while price is always an important factor, the credit rating and documentation requirement become paramount.

Chart 1: Rate Cap Payout

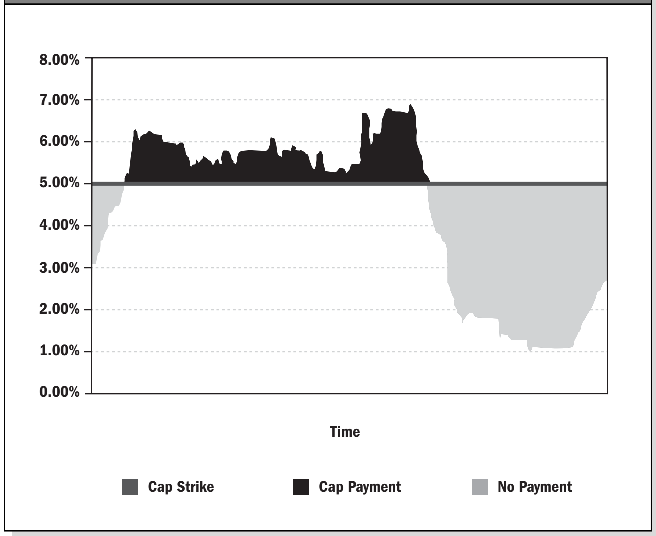
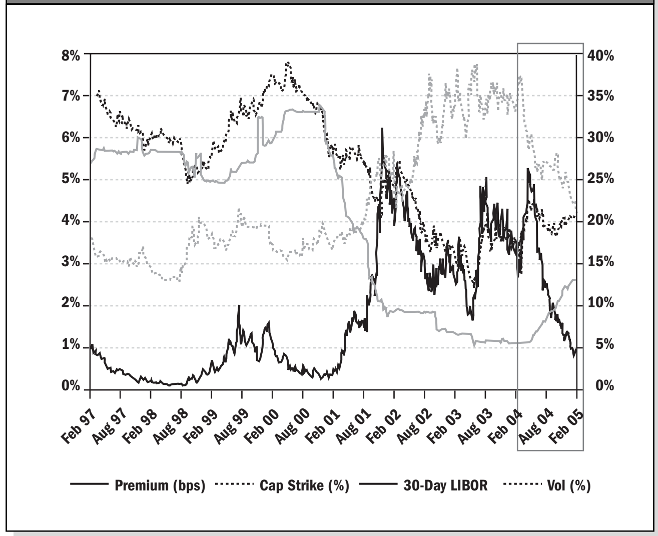


Chart 2: Historical Data



How is an Interest Rate Cap Agreement Documented and What Key Protections Should You Require In Order to Maximize Your Interest Rate Protection?

The basic documentation applicable to most Rate Caps includes an International Swap Dealers Association Inc. (ISDA) Master Agreement ("Master Agreement"), a confirmation setting forth the particular economic terms of the particular trade, a schedule to tailor the Master Agreement provisions to the particular terms of the transaction, and a collateral assignment of Rate Cap assigning the rights under the Rate Cap to the lender, and ultimately, for loans headed to securitization, the securitization trust.

Master Agreement

The parties to a Rate Cap must first select a form of Master Agreement to apply to the transaction. These selections generally include: (1) a choice between the 1992 or 2002 form of Master Agreement and (2) a choice between the Local Currency-Single Jurisdiction or Multicurrency Cross Border form. For most Rate Caps, market participants select the 1992 (Multicurrency Cross Border) form of Master Agreement. This is mainly due to the fact that this form is predominant in the CMBS market and most loan documents are standardized to work with this form.

Confirmation

The confirmation contains the economic terms of the transaction. Lender and borrower must carefully check this document to ensure that the terms contained in the confirmation accurately reflect the economics of the transaction (and in particular, work with the loan documents). For example, it is important to confirm that the notional amount reflects the loan amount, that the strike rate reflects the cap rate in the loan documents, that the cap terminates and is effective on the dates specified in the loan agreement and that the various terms defined in the confirmation by reference to the 2000 ISDA Definitions, such as LIBOR and business day, match the relevant defined terms in the loan documents. Many times, a term like LIBOR, will have a different meaning in the 2000 ISDA Definitions as compared to the standard loan agreement definition and these differences need to be reconciled to avoid a mismatch. A mismatch is problematic for many reasons including potentially creating payment timing issues and creating different payment terms and measures for the cap provider versus the borrower and therefore not providing the protection intended. Another important category of verification in the confirmation is timing. Under the 1992 form of Master Agreement, the cap provider is provided with a three day notice and cure period. Therefore, to ensure the cap provider payments are received by the lender in time to make payments on the loan on the payment date required under the loan agreement, it is sometimes necessary to schedule cap provider payments three days prior to the payment date on the loan. It is in the best interest of the lender and borrower to ensure the timing, calculations and definitions in the confirmation are accurate to avoid any potential mismatch, to maximize the protection afforded by the Rate Cap and to ensure compliance, if applicable, with any rating agency requirements.

Schedule

The schedule to the Master Agreement is sometimes included as part of the confirmation (i.e. a long-form confirmation) or may be a document separate from the confirmation. The schedule allows parties to tailor the Master Agreement standard provisions to the particular transaction by specifying certain provisions that do not apply to the particular transaction and modifying certain provisions of the Master Agreement. It is standard for a schedule to a

Rate Cap to eliminate most, if not all, events of default and termination events that otherwise would be applicable to cap purchaser. The main reason is based on the premise that the cap purchaser has paid an upfront premium and has fully performed, therefore, the cap purchaser's actions following payment of the premium should not enable the cap purchaser to terminate the Rate Cap. Eliminating events of default and termination events benefits both the borrower and the lender in that it ensures the Rate Cap will remain in place. Failing to remove these events could result in an early termination of the Rate Cap and therefore result in the borrower being required under the loan documents to purchase a new Rate Cap which could be costly and could result in a delay in coverage. Another standard modification to the schedule is the incorporation of an additional termination event in the event the cap provider is downgraded below certain rating levels. In the event of a downgrade below such ratings levels, the cap provider is typically required to replace itself or provide other credit support acceptable to the rating agencies. This is beneficial for the lender and borrower in that it places the burden of obtaining and paying for a replacement Rate Cap on the downgraded provider in lieu of the borrower and also ensures that an entity with adequate financial strength is obligated to make payments to the lender. It is important to note that whether or not the cap provider makes a payment under the Rate Cap, the borrower is still fully obligated for that payment under the loan agreement. Therefore, ensuring that a sufficiently rated entity is required to make any required payments provides the borrower and lender comfort that the cap provider will have the financial strength to make any such payments. There are also various other prudent and customary modifications to the Master Agreement such as netting restrictions, prohibitions on cap provider from petitioning (or joining in a petition) to file the borrower into bankruptcy, restrictions on borrower's payment of costs and expenses to the cap provider, and provisions related to certain tax events. These modifications are beneficial to the borrower and the lender.

Collateral Assignment

Generally, the loan documents will include a collateral assignment of Rate Cap or pledge of the Rate Cap. This document is necessary to assign the rights and benefits of the Rate Cap to the lender. This ensures that cap provider payments made under the Rate Cap will be made directly to the lender. Typically, the cap provider executes and acknowledges the collateral assignment or pledge and agrees to make all payments to or at the direction of the lender.

Concluding Remarks

Interest rate cap agreements will continue to prove important tools in providing protection from rising interest rates to borrowers and lenders entering floating rate loan transactions. As demonstrated in the hypothetical, interest rate caps provide protection against unforeseen fluctuations in short-term interest rates that could otherwise jeopardize the borrower's ability to comply with debt service covenants. Properly documenting these transactions can ensure borrowers and lenders the maximum protection afforded by interest rate cap agreements and facilitate compliance with any rating agency requirements. ❑

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