Corridor Explanation

Corridors are frequently confused with their more common cousin – collars.

Unlike collars (cap and floor), corridors are just two caps - one bought and one sold. The primary intent is to obtain a cap at a lower cost. These savings come with additional risk, however, as the floating rate is not actually capped.

Logistics

Cap 1 – Borrower *Buys* a Cap

This is the traditional cap most Borrowers are familiar with. A cap is bought that limits the floating rate at some level. For example:

Notional	$100mm
Term	3 years
Strike	2.50%
Cost	$1,000,000

Cap 2 – Borrower *Sells* a Cap

The Borrower sells a cap at a higher strike back to the same bank. Most commonly, this is for the same notional amount and term, but these could be different. The strike is frequently 1.00% higher than the strike in Cap 1, but this can be raised or lowered.

Notional	$100mm
Term	3 years
Strike	3.50%
Cost	$ 300,000

Buy Cap	$1,000,000
Sell Cap	$ 300,000
Net Cost	$ 700,000

The cost of the caps is netted and Borrower pays $1,00,000 and receives $300,000 for a net cost of $700,000.

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Mechanics

If LIBOR never exceeds the higher strike (3.50% in this example), the Borrower will have bought a cap at 2.50% for 70% of the cost. There are three possible outcomes and Borrowers/Lenders should primarily focus on Scenario 3.

Scenario 1 – LIBOR never exceeds 2.50%
Neither cap ever comes into play.

Scenario 2 – LIBOR climbs between 2.50% but not above 3.50%
Cap 1 provides the usual protection and Borrower's rate does not exceed 2.50%.

Scenario 3 – LIBOR climbs above 3.50%
Once LIBOR exceeds 3.50%, the Borrower needs to pay the bank the difference. There is no credit exposure because the lower strike cap will always be more in the money than the higher strike cap.

Example - LIBOR is 3.80%

Cap 1 – Bank pays Borrower 1.30%
Cap 2 – Borrower pays Bank 0.30%

Net effect – Borrower receives 1.00%

If LIBOR resets at 3.80% and the Borrower receives 1.00%, the Borrower's net rate is 2.80%.

Example – LIBOR is 5.00%

Cap 1 – Bank pays Borrower 2.50%
Cap 2 – Borrower pays Bank 1.50%

Net effect – Borrower receives 1.00%

If LIBOR resets at 5.00% and the Borrower receives 1.00%, the Borrower's net rate is 4.00%.

Shortcut Calculation

The difference between the two caps creates a one for one drag on LIBOR once it exceeds the higher strike.

- If the spread between the two caps is 1.00%, simply subtract 1.00% from LIBOR to determine the net rate.
    - If LIBOR is 4.00%, the Borrower's net rate is 3.00%
    - If LIBOR is 5.50%, the Borrower's net rate is 4.50%

Other Considerations

- The strike on Cap 2 must be higher than Cap 1
- Both caps must be bought from the same bank (some exceptions apply)
- Corridors do not usually satisfy hedge requirements because the rate is not actually capped
- Raising the strike on Cap 2 will decrease the risk but also provide less upfront savings

Takeaways

If LIBOR never exceeds the higher strike, the Borrower will have bought a lower strike cap for a substantial savings.

Once LIBOR exceeds the higher strike, the delta between the two strikes creates a drag on LIBOR.

Corridors are ideal for Borrowers that believe LIBOR will rise but not necessarily rise dramatically. For example, if the Borrower believes LIBOR could exceed 2.50% but 3.50% seems unlikely.

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