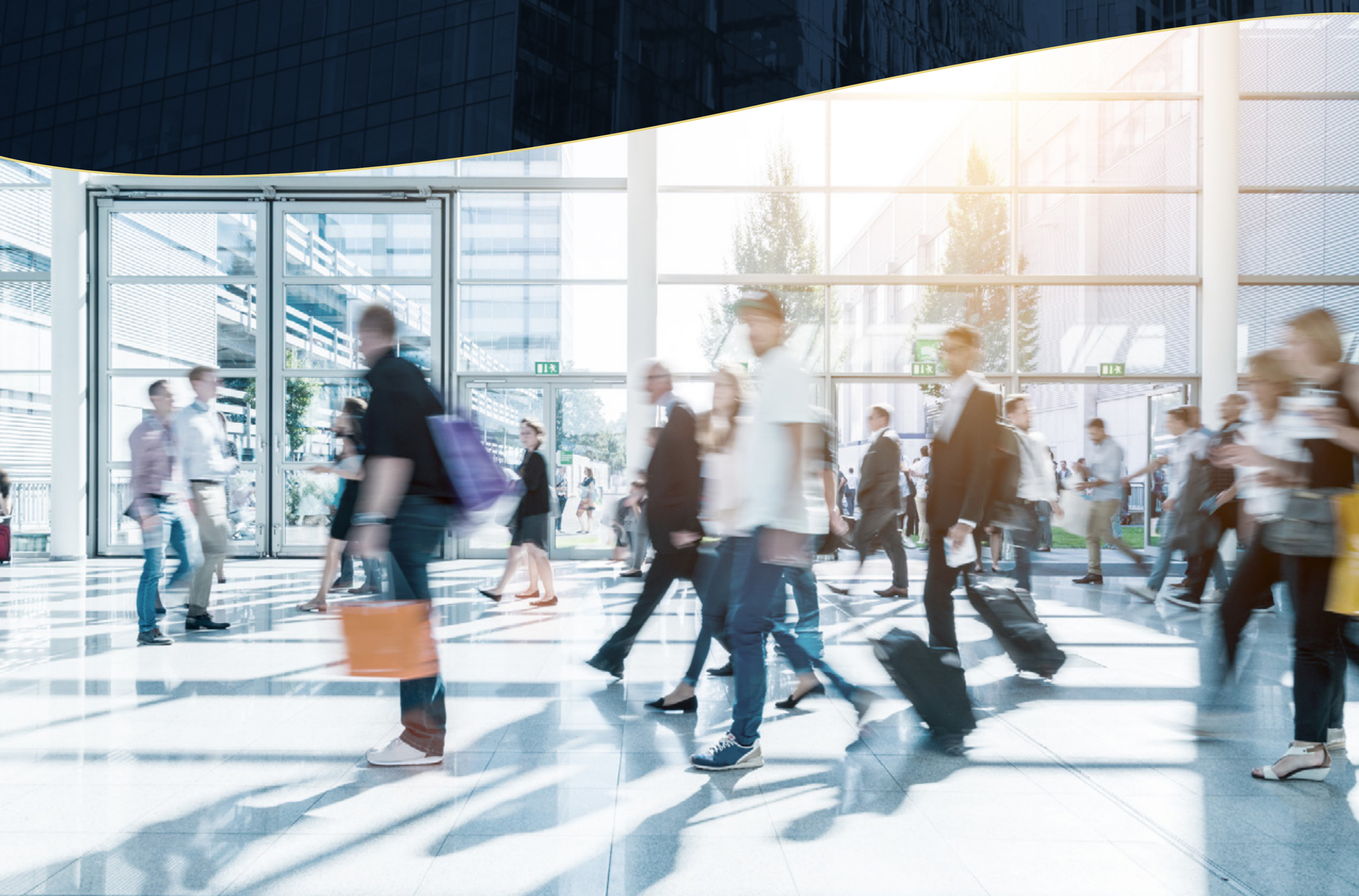
INTEREST RATE CAPS 101



INTEREST RATE CAP

An interest rate cap is a ceiling on a floating rate index, usually LIBOR. In exchange for this protection, the buyer pays an upfront premium. A cap is essentially an insurance contract on floating rates.

If LIBOR exceeds the strike, the Cap Provider reimburses the borrower for the difference. For example, if the strike is 1.50% and LIBOR resets for that month at 2.00%, the Cap Provider would pay the borrower 0.50%.

The borrower still pays 2.00% on the loan but receives 0.50% from the Cap Provider to buy the effective interest rate back down to 1.50%.

Interest rate caps are one of the most efficient ways to hedge against an increase in LIBOR and are most commonly used to hedge short term financings. Caps offer multiple advantages over other hedges, like swaps, such as:

- Known upfront cost
- No prepayment penalty
- Dramatically reduced transaction cost
- Can be bid out to a variety of banks to obtain lowest cost and best terms
- Retain exposure to LIBOR
- Clients can raise the strike to lower the cost, or lower the strike for more protection
- Easily transferable to other floating rate debt

WHAT DETERMINES THE COST OF A CAP?

Cap costs are driven by several factors, most notably:

- **Term**
- **Notional**
- **Rating requirements**
- **Strike**
- **Market Volatility**

WHO PROVIDES THE CAP?

Most large banks can provide caps; however, there may be limited interest given the size of the cap and whether or not the sponsor has a relationship with the bank. Lenders are frequently given competitive advantages to reward the relationship.

WILL ANY BANK BID?

No, many banks have decided that the effort to complete the pre-trade requirements simply to participate in an auction is not worth it.

Only two banks, SMBC and Goldman Sachs, will participate in an auction without a lending relationship. CBA will trade without a lending relationship, but will not participate in an auction.

HOW MUCH LEAD TIME IS NEEDED?

Generally, the cap process begins about two weeks before the loan closing; however, they can be completed in as little as two days if all parties are responsive.

WHEN DOES THE CAP ARRANGER GET INVOLVED?

The firm arranging the cap should provide indications as well as weekly updates to avoid surprises at the closing table. Additionally, they should review the term sheet requirements and LIBOR replacement language to ensure reasonable requirements.

TENOR IMPACT ON PRICING

Term has the greatest impact on cap pricing in today's market. A four year cap is significantly more expensive than a three year cap, while a three year cap is significantly more expensive than a two year cap.

With a relatively flat yield curve, the increased cost for additional term is not necessarily a function of higher expected rates, but the impact of a transparent Fed on the near-term likelihood of higher rates. The market feels less confident about its LIBOR projections the further out the time horizon goes.

RATING REQUIREMENT IMPACT ON CAPS

Lenders frequently dictate the rating requirements for any Cap Provider and can have a material impact on the cost of the cap.

These rating requirements should be negotiated during the term sheet stage.

HOW MUCH PROFIT DO BANKS MAKE ON CAPS?

Usually between $5,000-$10,000. Just as importantly, banks make far less on caps than on swaps.

HOW DO I PAY FOR THE CAP?

Most borrowers pay for the cap out of closing. The cap premium is due within two business days.

WILL A CAP HAVE A PREPAYMENT PENALTY?

No, caps only have value to the borrower. They can also be assigned to other floating rate debt.

WHAT CAP DOCUMENTS SHOULD I EXPECT?

Some important documentation requirements to consider:

- Bid package
- Dodd-Frank pre-trade requirements
- Confirmation
- Opinion
- Collateral Assignment
- Know Your Customer (KYC) documents

Lenders that require caps are very familiar with these and the cap arranger will help facilitate the circulation and execution of all necessary documentation.

CONCLUSION

Most large banks can provide caps; however, there may be limited interest given the size of the cap and whether or not the sponsor has a relationship with the bank.

Lenders are frequently given competitive advantages to reward the relationship.

Only three banks, SMBC, Goldman Sachs, and CBA will sell a cap without an existing lending relationship with the borrower. Of these three banks, only SMBC and Goldman Sachs will participate in an auction.

ANNEX A:
COMMON CAP PROVIDER BIDDING REQUIREMENTS

EASIER TO BUY FROM

SMBC Capital Markets, Inc.	• Will bid in auction • Size of trade is irrelevant • Easiest to buy from
Commonwealth Bank of Australia	• Will sell if triggers are A-/A3 • Will sell on a negotiated basis • Will not post collateral
Goldman Sachs	• Recently competitive • No relationship needed • Will accept downgrades
US Bank	• Will accept downgrades • Most aggressive on shorter terms • Recently Freddie approved
National Australia Bank	• Will bid with no downgrades • Doesn't require relationship • Should accept downgrades soon
Wells Fargo Bank, N.A.	• Will sell on a negotiated basis • Lending relationship required • Will accept downgrades
Royal Bank of Canada	• No auction participation • No relationship needed • Will accept downgrades
Natixis	• Existing KYC file required • Will not post collateral • Will accept downgrades
Bank of America	• Will bid if competitive • Will bid if lender • No downgrades accepted
Bank of New York Mellon	• Generally only bids on Agency caps • Only if competitive
Santander Bank	• Only if lender • Downgrades not accepted
Citizens Bank	• Only if lender • Downgrades not accepted
HSBC	• Only if lender • No auction participation
Barclays Bank	• No auction participation

HARDER TO BUY FROM

**while some banks may meet a lender's high rating requirements, they may not be able to participate if the loan is securitized*

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