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A Primer on Interest Rate Caps

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When the interest rate on a mortgage financing is not fixed, the amount that a borrower may be required to pay may fluctuate depending on changes in the underlying index to which the “margin” or “spread” is tied. While a lender may be comfortable with its underwriting of a financing and the ability of its borrower to service its debt at closing, if the underlying index of a floating rate loan changes over time, the lender’s comfort and the ability of its borrower to service its debt will obviously change. To combat against interest rate volatility, borrowers and lenders usually agree to hedge the interest rate against the uncertainty in the market for floating rate loans. The most common form of such hedging is an “interest rate cap.”

An interest rate cap is a derivative whereby the interest rate cap provider (the “counterparty”) agrees to pay the interest which would be payable by the borrower over a strike price (the “strike”) on the notional amount (the principal amount) of the loan. Consequently, if the index of the loan rises above the strike, the counterparty, and not the borrower, is liable for the excess interest payment obligation. In this way, the borrower’s liability for payment of interest on the loan in question is always “capped” at an amount equal to the strike plus the spread.

As additional collateral for a loan, the borrower will purchase an interest rate cap and pledge it to the lender. Simply put, the interest rate cap is an insurance policy on a floating rate loan, which protects the borrower and the lender if the interest rate index rises above the strike during a specified period of time (the “term”). The term of the cap is usually coterminous with the initial term of the loan. If the loan is extended, extensions are usually conditioned on the purchase of a new interest rate cap for the extended period.

Caps are purchased upfront with a single payment at the closing of a loan. After the premium is paid, the borrower has no further payment obligations. Most lenders will require borrowers to purchase the interest rate cap as a condition to closing the loan. Lenders also require that the cap provider have a minimum credit rating from Moody's, S&P, Fitch or another rating agency. The interest rate cap is usually auctioned to a number of creditworthy financial institutions to secure the most favorable terms at the lowest premium price. Lenders will require the counterparty to maintain a certain rating level during the term. In the event that the counterparty does not maintain its rating, the borrower will typically be required to (i) replace the counterparty with a new counterparty that meets the qualifications and execute a new interest rate protection agreement, (ii) require the counterparty to supply a guaranty from a party meeting the ratings default, or (iii) cause the counterparty to deliver collateral to secure its exposure to the borrower in an amount acceptable to the lender and the rating agencies. In most cases, borrowers will choose either option (i) or (ii).

Since most caps are purchased through an auction process, a bid package is usually assembled for the bidders, which includes the agreed-upon terms of the interest rate cap, the timeline for which the auction must be completed, the assignment of interest rate cap protection agreement, and the form of confirmation. The confirmation describes the particulars of the transaction, such as the loan amount, payment dates, accrual periods and other pertinent dates, the rates, and other material items necessary to understand the parameters of the interest rate cap. It is important to review the confirmation and the bid package to ensure all terms are correct, and accurately reflect the terms of the transaction. At closing, the borrower will collaterally assign the interest rate cap agreement, which is additional collateral for the loan, and ensures the lender's right to receive payments under the agreement.

While interest rate hedging takes many forms, interest rate caps are the most common derivative in mortgage financing. As we understand the process, we expect the market and traditional requirements to make implementation of this aspect of mortgage financing a smoother and simpler endeavor.