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The Basics of Interest Rate Protection

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Interest rate protection is a hedging tool commonly used by lenders to mitigate the risk that an increase in variable interest rates could inhibit a property's ability to service its debt. Though a property owner may only see a slight, gradual increase in rental income over time, the market may see a significant spike in a floating rate at any time. In order to hedge the risk that borrowers can't meet heightened interest payments, many lenders will require borrowers to obtain a ceiling or "cap" on a floating rate index in the form of a derivative commonly known as an interest rate cap, allowing borrower and lender to shift exposure to a third party-rated entity at a predetermined cost.

An interest rate cap essentially acts as an insurance policy, where the purchaser (borrower) pays a premium to a third party so that should the specified event occur – in this case, should the agreed-upon floating rate index increase interest rates above the rate (or strike price) the property can foreseeably service – the third party will cover the difference. The purchaser pays a one-time, up-front fee to a rate cap seller (or counterparty), a rated financial institution, to lock in the maximum interest rate it will be required to pay on the loan. After the premium is paid, the purchaser has no further obligations – thus no further debt and no residual credit risk. Should interest rates increase above the agreed-upon "strike price," the borrower pays the interest amount and receives a payment from the rate cap seller in an amount equal to the interest which would have been due on what is known as a "notional amount" (which is the amount of the loan) for the difference between the strike price and the actual interest rate index payable for such period. By purchasing a cap, the borrower still benefits from the advantages of a variable rate loan and potential rate declines but now has the additional security of a maximum interest rate, allowing it to make its loan payments even if interest rates skyrocket. Usually, the interest rate cap is auctioned out to a number of banks to secure the most favorable terms and lowest price for the premium. This is sometimes done post-closing, but the parties agree upon terms of the bid package for the auction beforehand; such package also usually includes the timeline for which the auction must be completed. The finalized terms should conform with the terms negotiated in the loan agreement. Review should specifically scrutinize payment dates for the cap purchaser and cap provider, the reset date for determining the floating rate index and the formula for determining floating rate calculation periods.

The cost of the cap is based on the seller's risk exposure, which is determined by a number of factors, including the term the agreement covers, the percentage of the strike compared to current market interest rates, the notional value of the loan, the volatility of the market and the bank's rating requirements.

The duration of the cap has the greatest impact on the premium amount. This is due to the uncertainty of floating rate projections over a long period of time and the Federal Reserve's transparency on the likelihood of rates in the near-term. The longer the period requested to be covered, the higher the cost of the premium, as the risk exposure increases due to uncertainty of the market and resulting interest rates. Because of this, most borrowers purchase a two-year cap agreement. Extensions of the loan are then conditioned on the purchase of a new rate cap for the extended period, the price of which can differ from the initial purchase. It's important to note, however, that the cap agreement only protects from fluctuations in the interest rate environment during the term of the cap, by insuring each month's interest payment. The interest rate cap won't help if, at the expiration of the agreement, rates are prohibitively high and the borrower can't refinance or sell.

Rating requirements of the institution providing the cap also impact the premium amount. Many lenders will require the cap provider or "counterparty" to meet and maintain a certain rating level. This is especially true for loans slated to be securitized, due to the rating agencies' specific commercial mortgage loan standards. Higher rating requirements will increase the cost of the cap and shrink the pool of banks bidding, as well as the pool of banks the cap provider can potentially replace itself with, if necessary. Determined at the outset, the downgrade trigger is the rating threshold below which the cap provider is no longer qualified to provide the cap for that loan. If the provider falls below the downgrade trigger, the borrower is usually given the option to (i) replace the interest rate protection agreement with one from a new provider meeting the qualifications, (ii) cause the provider to deliver collateral to secure its exposure to borrower in an amount acceptable to the lender and the rating agencies, or (iii) require the provider to supply a guaranty from a creditworthy entity meeting the qualifications. In practice, the options usually implemented are options (i) or (iii) since determining an appropriate amount of collateral can be difficult as risk profiles of interest rates and of the provider can and do change frequently.

Rate cap agreements are typically entered into at closing, and all right, title and interest to receive payments under the agreement are assigned by borrower to lender as additional collateral for the loan, until the expiration of the agreement or the loan is repaid in full. As such, in the case of a foreclosure, the winning bidder will also receive the remaining term of the rate cap.

However, in environments such as our current market climate, when floating rate indexes reflect low interest rates, some borrowers have been successful in negotiating an agreement not to purchase a rate cap unless and until rates rise above a certain percentage and maintain that level over a certain period of time.

While interest rate protection agreements are a common and useful way to hedge risk against uncertainty in a floating rate loan, there are many factors that must be considered when negotiating terms of a bid package and considering the cost of the premium.