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That's 'Interest'ing

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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.

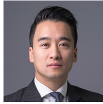
Caps are purchased upfront with a single payment at the closing of a loan. After the premium is paid, the borrower has no further payment obligations. Most lenders will require borrowers to purchase the interest rate cap as a condition to closing the loan. Lenders also require that the cap provider have 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.

Sustainability-Linked Loans Series, Part 1 – Introduction to Sustainability-Linked Loans



By **William Lo**
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In our last few editions of *REF News and Views*, we featured the Green Loan Series of articles in which we discussed the emergence of "green loans" and the Green Loan Principles – those principles that form the proposed framework for market standards, guidelines and methodology to be adopted across the green loan market.

In the next series of articles, we want to focus on sustainability-linked loans ("SLLs"), which also emerged alongside green loans as a result of the movement towards greater awareness and improving environmentally and socially beneficial outcomes in the way corporates and lenders effect their lending, investment and other business decisions. Whilst green loans and SLLs are similar in their macro mission towards environmental and social sustainability, there are some important differences in their approach. We look to explore this further in this Sustainability Linked Loans series of articles.

What is a sustainability-linked loan?

SLL is defined as any type of loan instrument and/or contingent facility (*e.g.*, bonding line, guarantee line, letter of credit) that incentivises the borrower's achievement of ambitious, predetermined sustainability performance objectives.

The borrower's sustainability performance is measured by using sustainability performance targets ("SPT"), which can include key performance indicators ("KPI"), external ratings and/or equivalent metrics which measure improvements in the borrower's sustainability profile. These can include measures related to matters such as energy efficiency or sustainable sourcing of raw materials and supplies.

How are sustainability-linked loans different from green loans?

There are three key differences between SLLs and green loans:

- **Purpose**: There is no use of proceeds requirement for an SLL; in fact, many SLLs in the market are for general corporate purpose loans. Instead, SLLs look to improve the borrower's sustainability profile by aligning loan terms with the borrower's performance against the relevant SPTs. This is in significant contrast to green loans, which are principally categorised by the way in which the proceeds are used towards an eligible green project – that is, the underlying green project investment, the management of the proceeds, and reporting.

- **Pricing**: A key incentive for a borrower in entering into an SLL is the pricing adjustment that can be awarded to it based on its performance against an agreed set of KPIs and SPTs, external ratings and/or equivalent metrics. The principle therefore is that if the borrower meets the agreed targets, then the

margin on the loan will decrease accordingly. It is often set to work in reverse, also, such that if the borrower fails to meet its targets then the margin will increase.

- **Flexibility**: With the focus on general performance as opposed to a specific project itself, SLLs provide greater flexibility in their application and use case, opening up the green and sustainable loans market to a broader range of companies that may not otherwise have any projects that are specific to a green project.

In the next article in this Sustainability-Linked Loans series, we will introduce the Sustainability-Linked Loan Principles, which were published in order to provide a framework to help market participants understand and identify the key components in establishing sustainability-linked loans.

Lombard v Skyjets: Key Takeaways for Lenders and Restructuring Professionals

The recent English High Court decision of *Lombard North Central Plc v European Skyjets Ltd* [2022] EWHC 728 (QB) provides some important guidance for lenders and restructuring professionals when communicating with distressed borrowers. Actions will speak louder than words – whether in the form of a “no waiver” provision in a contract or an express reservation of rights – when a court is considering a lender’s response to a borrower’s default on its financing arrangements. While there are no massive surprises to emerge from Foxton J’s decision, the breadth and creativity of some of the arguments advanced by the borrower’s lawyers nonetheless provided the Court with the opportunity to provide additional certainty to market participants.

Read our Clients & Friends Memo here.

Recent Transactions

Here is a rundown of some of Cadwalader's recent work on behalf of clients.

- Represented the lender in a series of nine uncrossed loans totaling $144 million in connection with acquisition financing of a portfolio of nine extended stay hotels across eight different states.
- Represented the borrower in connection with a $35 million mortgage financing of a creative office property in Los Angeles County, California.
- Represented the lender in connection with a $319.05 million mortgage loan secured by a data center in Virginia.
- Represented the lender and administrative agent in connection with a mortgage loan in the maximum principal amount of $765 million and secured by up to 42 industrial properties.
- Represented the manager of a commercial real estate investment fund in connection with a $20 million preferred investment in a joint venture owner/operator of an office complex located in Houston, Texas.
- Represented a client in performing due diligence and negotiating a co-lender in connection with its purchase of a 50% interest in a $400 million loan secured by a 27-property portfolio of West Coast industrial assets being repositioned by the borrower.
- Represented an insurance company as administrative agent and lender in originating an approximately $400 million loan secured by a portfolio of 11 class A triple-net leased properties located across four states.