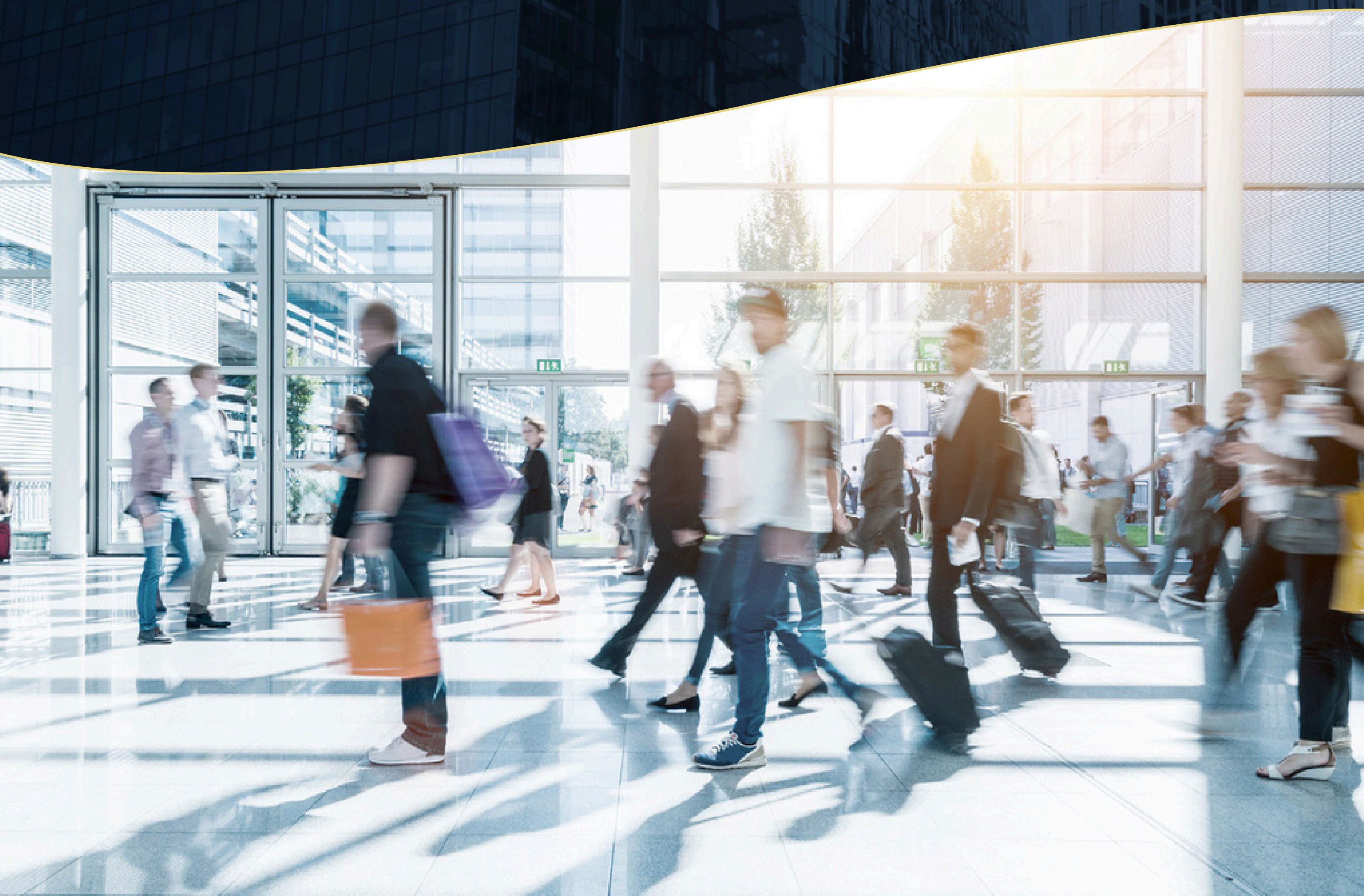
PENSFORD

INTEREST RATE CAPS 101



INTEREST RATE CAP

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

If SOFR exceeds the strike, the Cap Provider reimburses the borrower for the difference. For example, if the strike is 3.50% and SOFR resets for that month at 4.00%, the Cap Provider would pay the borrower 0.50%.

The borrower still pays 4.00% on the loan but receives 0.50% from the Cap Provider to buy the effective interest rate back down to 3.50%.

Interest rate caps are one of the most efficient ways to hedge against an increase in SOFR 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 the lowest cost and best terms
- Retain exposure to SOFR
- 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, the pool of eligible providers can vary depending on the structure of the cap and whether or not the sponsor has a relationship with the bank. If your lender is able to offer a cap, rewarding that relationship is another factor to consider when selecting a provider.

WILL ANY BANK BID?

No, many banks' ability to bid is dependent on a variety of factors such as, index, lender's hedge requirements, and relationship with sponsor.

However the pool of third party cap providers has greatly expanded as of recent and there are several banks willing to auction without a lending relationship.

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 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 lower rates. The market feels less confident about its SOFR 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 following the date of execution.

WILL A CAP HAVE A PREPAYMENT PENALTY?

No, once you purchase the cap it will only be an asset to you and can always be unwound to recoup the remaining value if there is any.

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

Market expectations, term length, strike rate, and lenders counterparty requirements are a few factors that impact the up front cost of a cap at execution.

Most large banks can provide caps; however, the pool of eligible providers can vary depending on the structure of the cap and whether or not the sponsor has a relationship with the bank.

In today's market several banks are willing to sell a cap without an existing lending relationship.

ANNEX A: COMMON CAP PROVIDER BIDDING REQUIREMENTS

EASIER TO BUY FROM

SMBC Capital Markets, Inc.	• Will bid in an auction • Relationship not required • Accepts high ratings and downgrades
Wells Fargo Bank, N.A.	• May bid in an auction • Relationship not required • Accepts high ratings and downgrades
Goldman Sachs	• Will bid in an auction • Can only proceed with One Borrowing Entity • Recently Freddie Approved • Accepts high ratings and downgrades
US Bank	• Will only trade direct • Relationship not required • Freddie Approved
Royal Bank of Canada	• Will bid in an auction • Relationship not required • Cannot trade on Agency Caps
Bank of New York Mellon	• Will auction on Agency caps • Can only proceed with One Borrowing Entity • Cannot proceed with tax gross up language
MUFG	• May bid in an auction • Relationship not required • Cannot bid on Agency Caps
JP Morgan	• May bid in an auciton • Relationship is required • Recently Freddie approved
Bank of America	• May bid in an auction • Relationship is required • Cannot proceed with tax gross up language • Cannot bid on Agency caps

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*

PENSFORD

READY TO DO BUSINESS WITH US?

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