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Introduction: Caps are Historically Better but Less Used than Swaps

For more than twenty years, any borrower who used interest rate caps to hedge their floating rate interest risk would have had much lower interest costs than if they had used interest rate swaps. Surprisingly though, most borrowers choose swaps instead of caps to hedge. Why?

Background

When companies borrow variable rate bank debt they often use an interest rate hedge to protect themselves against rising interest costs (this is sometimes even a loan requirement). When deciding on a hedge, borrowers typically consult with their bank's risk management group, which also then sells them the hedge.

For at least twenty years, LIBOR rates have *averaged* below swap rates the vast majority of the time. Any borrower using caps instead of swaps would have saved significant interest costs. Unlike a swap, a cap allows a borrower to benefit from low LIBOR rates and still have a maximum rate (cap level).

Although there are many circumstances where a cap makes more sense than a swap, *by a 10-1 margin borrowers end up choosing swaps instead of caps.*

Reasons why Caps are Underutilized

1. Banks are biased against Caps

A bank will usually not even mention the idea of a cap as a possible hedge for a loan. This is because banks make more money selling swaps than they do selling caps. A bank has a natural incentive to sell a borrower the largest, longest swap possible, since this will maximize the bank's profit.

A bank's profit margin on a cap is often one-tenth, or less, of the bank's profit margin on a swap. Since a cap has no credit risk for a bank, a borrower can purchase a cap from any bank, even if has no credit relationship with the bank. This is the primary reason there is more price competition and less margin available to banks on caps.

2. Caps are seen as "Expensive"

Caps require the up-front cash payment of a premium similar to insurance. Borrowers, like all

of us, hate to pay fees, even though it might be in our best interest. Like insurance, a cap pays off for the borrower only if an unlikely event occurs. Caps are “disaster protection”. A bank may play on a borrower’s aversion to paying the cap fee, and the risk of rates rising, in order to sell the borrower a swap instead of a cap.

A cap fee is like a multi-year insurance premium. To fairly compare the cost of a cap vs. a swap, the cap’s up-front cost should be amortized over its life. The cap’s cost will appear much lower when measured like this.

Caps are priced relative to the alternative swap rate, not the current level of LIBOR.

Cap Cost Example

- A \$10 million 4-year 3.00% cap on LIBOR costs only 125,000, or about .32% as a rate equivalent (not a large cost for four years of rate protection).
- A 4-year swap currently costs 1.60%, which is lower than the cap rate, but much higher than LIBOR at .18%. If LIBOR stays at current levels, the cap pays for itself in 10 months. Although the borrower will have more rate risk than with the swap, LIBOR rates would have to rise quickly, and significantly, in order to deplete the variable rate savings.

Cap Benefits

Caps should always be considered in any debt hedging analysis, especially if the borrower has a lower rate forecast for LIBOR than that implied by the swap market.

Though they do not offer a guaranteed fixed rate as low as a swap, caps offer much more financing flexibility, and typically at a lower cost.

- Caps allow the buyer to “have their cake and eat it too”, since the buyer enjoys the low level of floating rates while holding the protection of having a maximum rate ceiling. This maximum flexibility requires an insurance-like up-front payment.
- The cap becomes an asset for the borrower, having been fully paid for up-front. It therefore carries no risk of a future termination payment, and can never have a negative value. It can be sold back to the bank if not needed in the future.

Summary

When deciding whether to choose a swap or a cap, a borrower should compare the current swap rate to historical *LIBOR* rates...not historical *swap* rates. The decision should be not when to swap, but whether to execute a swap or a cap. Make sure your loan requirements allow you to utilize a cap instead of a swap to hedge your rate risk.

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