

# Hedging Floating Rate Loans in a Volatile Market

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March 2009 - Having trouble obtaining new fixed-rate debt? You are not alone. The virtual dismantling of the conduit lending market and recent credit constraints have made it nearly impossible for borrowers to find ten year fixed-rate financing. Floating rate loans are somewhat more accessible, but with historically low LIBOR and treasury rates, the common sentiment among borrowers is that there is nowhere for rates to go but up. To address this problem, we recommend two fairly common hedging solutions – an **Interest Rate Cap** or **Interest Rate Swap**.

When a borrower enters into an **Interest Rate Cap**, they pay an upfront fee to a cap provider and agree to a strike rate and term. The cap provider then makes payments to the borrower if interest rates exceed the strike rate during the term of the cap. The cap can cover the entire loan amount or a portion of the loan amount. Reducing the dollar amount of the cap reduces the cost of the cap. On the other hand, reducing the strike rate raises the cost of the cap. Another factor that impacts cap pricing is market volatility. Less volatility translates to a lower cap price. Once the initial purchase price is paid, the borrower will never owe the cap provider another payment, even if the borrower later refinances the loan or sells the property and terminates the cap early. It is not unusual for a lender originating a floating rate loan to require that the borrower purchase an interest rate cap.

**Example:** Cramer has a floating rate loan (\$10mm, 5yr term, 1m LIBOR + 1.500%). He wants protection from a drastic interest rate increase, but he still wants to benefit from decreases in the rate. Cramer purchases a \$10mm Interest Rate Cap with a 4% strike rate versus 1m LIBOR. With a loan margin of 1.50%, Cramer is capping his all-in coupon at 5.50% (4.00% LIBOR Strike Rate + 1.50% loan margin).

- **If 1m LIBOR < or = 4%**  
Cramer receives nothing from the cap provider nor does he pay anything. The interest on his loan is 1m LIBOR + 1.50%.
- **If 1m LIBOR > 4%**  
Cramer receives a cash payment from the cap provider each month that is equal to the difference between 1m LIBOR and 4% on \$10mm. The net effect of the cap provider's payments is to cap Cramer's interest rate at 5.50%.

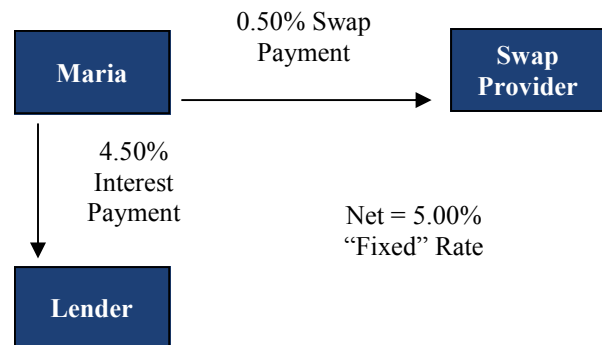
Another hedging solution for a floating rate loan is an **Interest Rate Swap**. Here, the borrower synthetically fixes the rate on a floating rate loan by entering into a swap agreement for a specified rate with a swap provider. Assuming the floating rate loan and the swap are tied to the same reference rate or index, the borrower receives money from the swap provider if the interest rate on the floating rate loan is above the swap rate, and the borrower pays money to the swap provider if the interest rate on the floating rate loan is below the swap rate. The net effect of the swap and floating rate loan taken together is a fixed rate resulting in fixed, predictable payments. A swap provider may require a guaranty and/or collateral to be posted in order to get comfortable from a credit perspective with the borrower's

ability to make payments on the swap. Also note, if the loan is prepaid before the swap term expires, then the swap will need to be terminated. Depending on where interest rates are at the time of the termination, the borrower may end up paying termination/breakage costs.

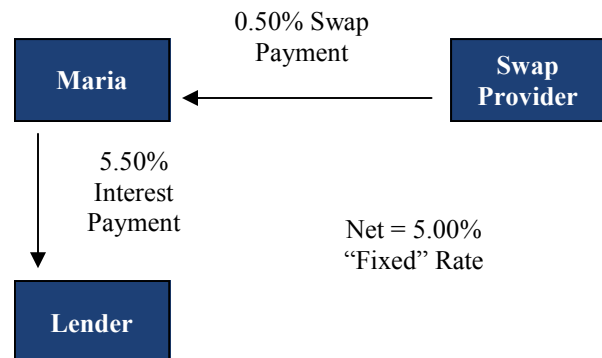
## Example:

Maria has a floating rate loan. By entering into an Interest Rate Swap with a fixed rate of 3.50%, the net effect of the swap payments is to synthetically fix the interest rate on her floating rate loan at 5.00% (3.50% Swap Rate + 1.50% Credit Spread).

- In Month 1, assume 1m LIBOR is 3.00%. Maria pays the Swap Provider 0.50% (3.50% - 3.00%) and the Lender 4.50% (3.00% + 1.50%), making her all in interest costs 5.00% (0.50% + 4.50%).



- In Month 2, assume 1m LIBOR is 4.00%. Maria receives 0.50% (4.00% - 3.50%) from the Swap Provider and pays the Lender 5.50% (4.00% + 1.50%), making her all in interest costs 5.00% (-0.50% + 5.50%).



Even in the midst of unprecedented market conditions, borrowers still have a number of options to address the uncertainty associated with floating rate loans. Interest Rate Caps and Interest Rate Swaps are two of the more common solutions. A hedging specialist can recommend other custom hedging solutions tailored to your specific situation.

For more information visit [www.hedgewithease.com](http://www.hedgewithease.com).