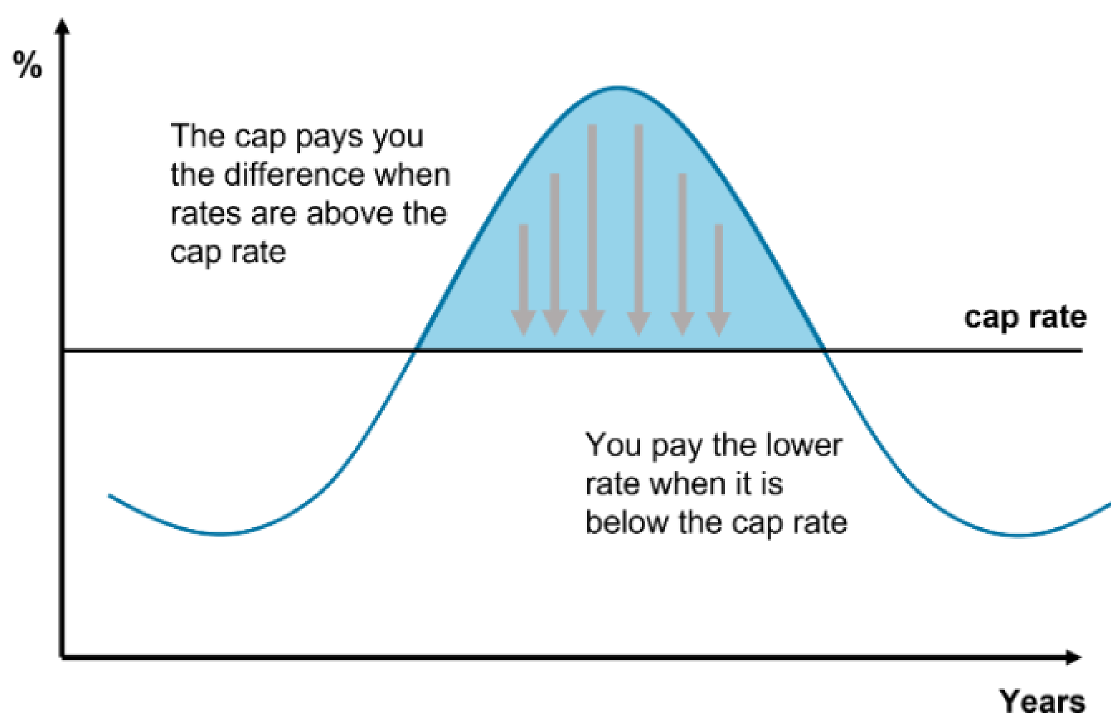
Interest rate caps

Interest rate caps are used by borrowers to reduce risks. This article explains the mechanics, benefits and risks of caps and how caps apply to borrowers with fixed or variable rate loans.

How caps work

An interest rate cap acts like insurance against high interest rates. The cap buyer specifies the amount of borrowing to protect, the duration of that protection and the cap rate, which is the level of interest rates above which the cap protection kicks in.

Caps protect variable rate borrowers against interest rates rising above an agreed cap rate while allowing them to benefit from low interest payments when rates are below the cap rate. The borrower pays a premium for the cap. When rates are above the cap rate, the borrower receives compensating payments from the cap. When rates are below the cap rate, the borrower simply pays the lower rate.



Benefits of caps

- **Protection against high interest rates:** When interest rates rise above the cap rate, the cap owner receives compensating payments, offsetting higher loan costs.
- **Cheaper borrowing costs:** A cap does not lock a borrower into a fixed minimum rate of interest. The borrower can benefit from lower loan payments when interest rates are below the cap rate.
- **Affordability:** Borrowers with interest rate caps have less risk of being unable to meet loan payments when rates rise. The cap gives the borrower extra funds when interest rates are high.
- **Simplicity:** Borrowers pay a one-off initial premium to buy a cap. That is their only outgoing payment. After that, they receive compensating payments when rates rise above the cap rate. Caps have no running costs or exit costs.

- **Flexibility:** Caps are separate from the loans they protect. The borrower may change their loans without affecting the cap (and vice-versa). A single cap can protect a pool of different loans for up to 20 years.
- **No hidden traps:** Fixed rate products may impair borrowers' credit status and expose them to early exit costs. In contrast, once the premium has been paid, a cap never has an exit cost.

Risks of caps

The worst that can happen is the buyer pays the premium for the cap but receives nothing in return, for example if the interest rate stays below the cap rate for the life of the instrument.

Applications of caps

Caps for variable rate borrowers

Buying a cap allows a borrower with a tracker mortgage or variable rate loan to benefit from low interest payments when variable rates are low, but to receive compensating payments when rates are above the cap rate. Caps give better protection with more flexibility than fixed rates. A cap once paid for can never have an early exit cost. Caps are separate from the loans they protect and may be applied to existing loans as well as new ones. A single cap can protect a pool of different borrowings up to 20 years.

Caps for fixed rate borrowers

In recent years, many borrowers have taken out fixed rate loans. Some of these fixed rates will become due for refinance over the coming months and years. Borrowers wishing to protect themselves now against future rate increases may buy a forward starting cap. Typically, the start date of the forward starting cap is set to match the expiry date of the existing fixed rate loan. When the fixed loan expires, the borrower may refinance with a variable rate, with cap protection already in place. By not being locked into a new fixed rate, the borrower can still benefit from lower interest payments if rates are below the cap rate.

Summary

Traditional borrowing strategies create risk. Fixed rates expose borrowers to the danger of being trapped in above-market rates and the risk of early exit penalties. Variable rate loans *without caps* expose borrowers to the risk of higher payments when interest rates rise. Caps reduce risk for borrowers. A variable rate loan with a cap is less risky than the traditional alternatives. Caps also reduce risk for lenders. A borrower with a cap is less likely to default on their loan.

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This article was written by Nick Stoop. Nick has 30 years' experience in interest rate hedging and SME finance and has worked as an expert advisor to SMEs and UK regulators including the Treasury Select Committee. Nick is the founder of Cap-It (www.capit.co.uk).

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