

# Capped loans – a suitable option?

During the long period of low interest rates which followed the 2008 financial crash, UK borrowers became increasingly dependent on fixed rate loans as a source of funding. Fixed rate loans are widely viewed as a simple way to protect against possible future increases in interest rates.

The risks of fixed rate loans are not always fully understood and, in any event, were largely ignored while the absolute level of interest rates remained at record lows. But as interest rates have returned to pre-2008 levels, the dangers of fixed rate loans have increased.

If interest rates fall, fixed rates can create serious problems for borrowers, who risk becoming trapped in expensive arrangements. Fixed rate loans may be difficult to exit without incurring break costs, which could be substantial in terms of the amounts borrowed. The contingent liabilities created by the potential break costs can cause loan to value covenant breaches and place borrowers unwittingly in default of their loan obligations.

Capped loans are a safer option. The interest rate paid by the borrower is capped at an agreed maximum level, the cap rate. When the floating rate is below the cap rate, the borrower's interest rate is reduced accordingly. The borrower does not risk becoming trapped in an expensive arrangement. Capped loans can normally be terminated without penalty and do not create the same contingent liabilities as fixed rate loans.

Capped loans have been out of fashion for many years. But in the current interest rate environment, capped loans may be a more suitable option for both lenders and borrowers.

This note outlines very briefly:

1. The advantages of capped loans;
2. Converting existing loans into capped loans; and
3. The Capped Loan Calculator.

## 1. The advantages of capped loans

### Benefits for borrowers

Capped loans have obvious benefits for borrowers, who get the best of both worlds whichever way interest rates move. If rates fall, the borrower pays the lower rate; if rates go up, the borrower pays no more than an agreed maximum.

Borrowers with access to caps and floors may convert normal fixed and floating rate loans into capped loans. The strategy gives borrowers a wider choice of potential lenders and the opportunity to access larger loan amounts at lower costs than might otherwise be available.

### Benefits for lenders

Lenders offering capped loans have the opportunity to expand loan distribution, reduce risks and increase fee income.

- **Expanded loan distribution** - the simple addition of a cap or floor to an underlying fixed or floating loan converts it into a capped loan, leaving the lender's net cash flows unchanged. Lenders offering normal fixed or floating rate loans may distribute those

same underlying loans as capped loans, making their existing loan offerings attractive to a wider range of potential borrowers.

- **Reduced risks** - capped loans have superior credit characteristics compared to fixed rate loans or uncapped floating rate loans. Default risk and interest coverage are improved because borrowers with capped loans tend to pay less interest. In addition, the lender's ownership of the cap or floor increases the value of its security and so improves loan to value ratio.
- **Increased fee income** – lenders may earn more fee income via capped loans than otherwise via the underlying loans. Extra fee income could be in the form of an upfront percentage of the cap or floor premium, potential extra spread income via the cap or floor, or both. Increasing fee income while simultaneously reducing risks improves the lender's risk-adjusted returns.

## 2. Converting existing loans into capped loans

**Floating rate loans** are converted into capped loans simply by adding a cap. **Fixed rate loans** are converted into capped loans by adding a floor in the borrower's favour.

Any fixed or floating loan can be converted into multiple alternative capped loans. The features of each alternative vary according to the chosen strike rate of the cap or floor and the extent to which the premium is paid upfront or built into the loan.

The variable features are:

- **Initial rate** – the loan interest at the initial floating rate;
- **Minimum rate** - the loan interest when the floating rate is zero;
- **Maximum rate** - the loan interest when the floating rate is at or above the cap rate of the loan; and
- **Upfront premium** – the amount of upfront premium payable by the borrower (if any).

The capped loan to be selected from the multiple alternatives available depends on which loan features are most important to the borrower and the lender.

### Initial rate

The initial rate of the capped loan is likely to be of importance to the borrower. In the current interest rate environment, where the forward curve reflects market expectations of future falls in interest rates, the initial rate of a capped loan may also be its maximum rate, meaning that future interest rate settings may be lower than this figure.

### Minimum rate

The minimum rate of the capped loan reflects the best-case scenario for the borrower when the floating rate is set at zero. If the capped loan is created by a fixed rate loan with a floor with its premium paid upfront and having a higher floor rate than the fixed rate, then when the minimum rate applies the borrower will receive (rather than pay) interest under the capped loan.

### Maximum rate

The maximum rate of the capped loan applies when the floating rate is set at or above the cap rate of the capped loan, reflecting the worst-case scenario for the borrower. The maximum rate is often a key factor when calculating affordability.

### Upfront premium

The premium payable for the cap or floor element of the capped loan depends on factors including the loan amount to be protected, the duration of that protection and the strike rate of the cap or floor. The premium may be paid upfront or in instalments over the life of the loan. Where the premium is paid in instalments, the capped loan interest is increased accordingly, but there is no upfront payment.

Borrowers may use the [Instalments Calculator](#) for an indication of the instalment payments required to fund a given upfront amount.

## 3. The Capped Loan Calculator

The [Capped Loan Calculator](#) shows the alternative capped loans that may be created from any underlying fixed or floating rate loan. Users simply enter the details of the underlying loan or loans and select whether the premium is to be paid upfront or in instalments. The calculator generates a table of alternative capped loans that may be created from the underlying loan or loans.

Users can sort the table according to the features described above, i.e. by initial rate, minimum rate, maximum rate or by upfront premium (if applicable). Further details of each alternative capped loan, including its interest rate at different levels of the floating rate, may be viewed by clicking the relevant “More info” button.