

Smart Cap

Overview

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1.0 Scenario

You have floating rate borrowings. Your view is that short-term interest rates will remain relatively stable over the medium term. Given that short-term rates are lower than long term rates, you prefer to fund on a floating rate basis. There is a cost associated with paying the higher rate if an interest rate swap is utilised.

However, as a prudent manager, you recognise the risk inherent in running an unhedged position. The purchase of a cap would allow you to take advantage of the relatively lower short-term rates, but you do not want to pay the premium associated with the option.

You are looking for a low (or zero) premium strategy that caps your maximum upside cost of funds and allows you to participate if rates fall. However you will be prepared to pay a higher (but known) cost of funds should rates fall below a certain level.

2.0 Smart Cap

A Smart Cap is an option that provides two major benefits associated with a vanilla cap - protection against rate rises and the ability to benefit from lower short term rates. However, if rates fall below a minimum level, the cost of funds reverts to the cap rate.

Two levels are set when the Smart Cap is purchased; the cap strike rate and the floor strike rate. The cap strike rate will be higher than the floor strike rate. For this structure, rates are capped at all levels above the cap strike rate and at all levels below the floor strike rate.

On each rate set date, there are three possible outcomes:

- if the floating rate sets at or above the cap strike rate, the cost of funds for that roll is the cap strike rate
- if the floating rate sets at or below the floor strike rate, the cost of funds for that roll is also the cap strike rate
- if the floating rate sets between the floor and cap strike rates, the cost of funds for that roll is the floating rate.

The payoff for a Smart Cap is similar to that of an interest rate collar, with the notable exception that once the lower floor strike rate is reached, the cost of funds reverts immediately to the higher cap strike rate (as opposed to a floor rate as with the collar). Since the cost of funds at lower rates is higher for the Smart Cap than the interest rate collar, the floor strike rate can be set at a lower level on the Smart Cap.

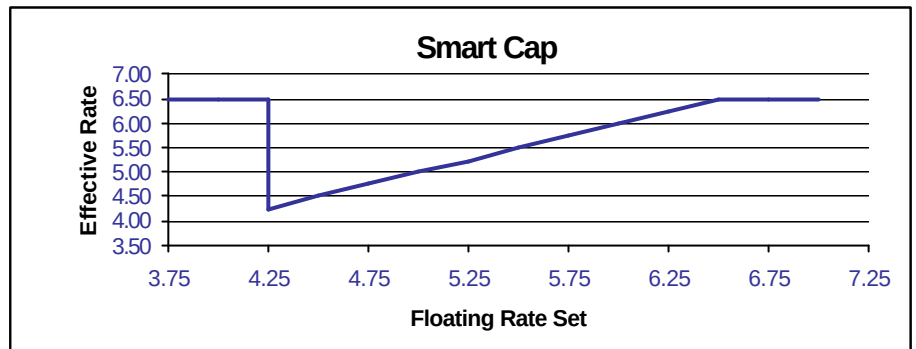
3.0 Effective Cost of Funds

Assumptions:

- 2 year Smart Cap (zero-cost)¹
- Floor strike rate 4.25%
- Cap strike rate 6.50%
- Maximum cost of funds 6.50%
- 2 year swap rate 5.35%

¹ All rates quoted in this example are exclusive of any fees (eg. line fee), which must be added to these rates to obtain an all up cost of funds.

The effective cost of funds for this structure is shown as follows:



Floating rate set	3.75	4.25	4.75	5.25	5.75	6.50	7.00
Effective cost of funds	6.50	6.50	4.75	5.25	5.75	6.50	6.50

4.0 Features and Benefits

- Potential to benefit from favourable interest rate movements until the floating rate falls to or below the floor strike rate
- The floor strike rate is lower than that which would apply for the interest rate collar strategy
- Risks are limited to a known worst case rate, namely the cap strike rate
- No premium payable for a Smart Cap

5.0 Constraints and Risks

- **Minimum notional: \$500,000**
- Should the floating rate be at or below the floor strike rate on any rate set date, the structure will revert to the cap strike rate
- May require additional resources to monitor and may not readily fit into existing management and reporting framework

6.0 Conclusion

The Smart Cap is a structured product that offers you a worst case rate for your hedge. You will pay a variable interest rate equal to the floating rate when the floating rate is within the range of the cap strike rate and the floor strike rate. Funding reverts back to the cap strike rate when the floating rate is at or beyond this range.