

Collar Explanation

Collars are frequently sold as an alternative to caps. They can be appealing because they allow a borrower to obtain a ceiling on a floating rate without the upfront cost of a cap.

Unlike caps, collars have credit exposure. For this reason, they behave more like swaps in many ways. Also unlike caps, this means borrowers must usually enter into a collar with the lender. This creates an incentive for a lender to propose collars as an alternative to caps.

Additionally, collars will require an executed ISDA and could have a prepayment cost.

Generally, a borrower buys a cap at a certain strike. Rather than paying cash for that cap, the borrower sells a floor back to the bank. This creates a floor and a ceiling, or collar, on the floating rate.

Logistics

Borrower Buys a Cap

This is the traditional cap most Borrowers are familiar with. A cap is bought that limits the floating rate at some level.

Notional	\$100mm
Term	3 years
Strike	3.50%
Cost	\$250,000

Borrower Sells a Floor

This is the part of the collar that creates credit exposure. The bank needs to underwrite the credit risk of being paid if the floating rate goes below the floor. The lender will use the underlying collateral to secure this exposure, giving it the same advantage it would have with a swap.

Generally speaking, the borrower will give the bank the strike rate for the desired cap (3.50% above) and ask the bank to solve for the floor. Usually, the floor is set at a rate that results in no upfront premium to the borrower.

In this example, the floor would need to be sold at 2.25% in order to require no upfront fee.

Over the next three years, the borrowers rate will float between 2.25% and 3.50%.

Mechanics

Cap - if the floating rate exceeds the cap, the bank reimburses the borrower the difference (just like a traditional cap)

Floor – if the floating rate falls below the floor, the borrower reimburses the bank the difference.

If the floating rate is between the floor and the ceiling, the collar doesn't have any impact on monthly payments.

Swap

In addition to comparing the collar to a cap, borrowers should also compare the collar to a swap.

Cap at 3.50%	\$250,000
Collar	2.25% - 3.50%
Swap	2.70%

Prepayment

If the collar is terminated before maturity, it could have a prepayment cost.

In general, the termination is simply the net value of the cap and the floor.

- If rates are expected to be above the cap with a low likelihood of dropping below the floor, the net effect should be a positive value to the borrower.
- If rates are expected to be below the floor with a low likelihood of exceeding the cap, the net effect should be a negative value to the borrower.

Conclusion

Collars can be attractive instruments, particularly for borrowers that want to avoid an upfront premium of a cap.

From a credit perspective, collars behave more like swaps and banks have greater incentive to offer these than caps.

Collars can have prepayment costs.

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