Kerius finance

Where serenity meets financial markets.

N°9 : Perspectives on The cap spread

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The « cap spread » in brief :

Strategy that consists in buying a cap (interest rate limit) while selling another cap with a higher rate ("strike") to offset the cost of the first cap.

Main drawbacks

HIGH MARKET RISK

By selling a cap at a higher rate, you stop the effectiveness of the hedge at that level and thereby take the risk that interest rates might rise above it. If this happens, the financing rate is no longer capped.

COMPLEXITY

Managing a cap spread is complex and requires a good understanding of derivatives and option pricing models.

TRANSACTION COST

These so-called structured strategies are subject to much higher bank margins at setup and, if necessary, during restructurings, for example after a rate hike period as is currently the case.

This product does not qualify for hedge accounting.

Why ?

- To meet the qualification for hedging, a strategy must guarantee a reasonable rate regardless of market conditions (including in the case of significant interest rate increases or decreases).
- This is not the case for this strategy which no longer generates a payout beyond the 'strike' of the sold cap, even if the Euribor is significantly above the strike of the cap bought.

What consequences ?

- The auditors must reclassify the strategy as an a standalone open (speculative) position.
- Fair value changes must be recorded in the financial results as they occur instead of being deferred via OCI (IFRS) or off-balance sheet (French standards) for hedging strategies.
- This can influence key financial ratios.

Key topic in the current situation

Rising interest rates and ineffective strategy

A « BEST-SELLER »

Over the last 12-18 months, in a context of rising hedging costs, banks have offered 'attractive' strategies that reduce the costs of hedges. Despite a context of sharply rising rates, some banks have been able to persuade their clients to bet that rates would not rise above 2 or 3%.

By having them sell options at these levels, which halted the effectiveness of the strategy and turned it into a financial expense optimization product suitable for periods of stability or slight rate increases, but not as a hedge.

Because of this option sale: the company's financial expenses are no longer protected beyond the upper level..

UNHEDGED DEBTS TODAY

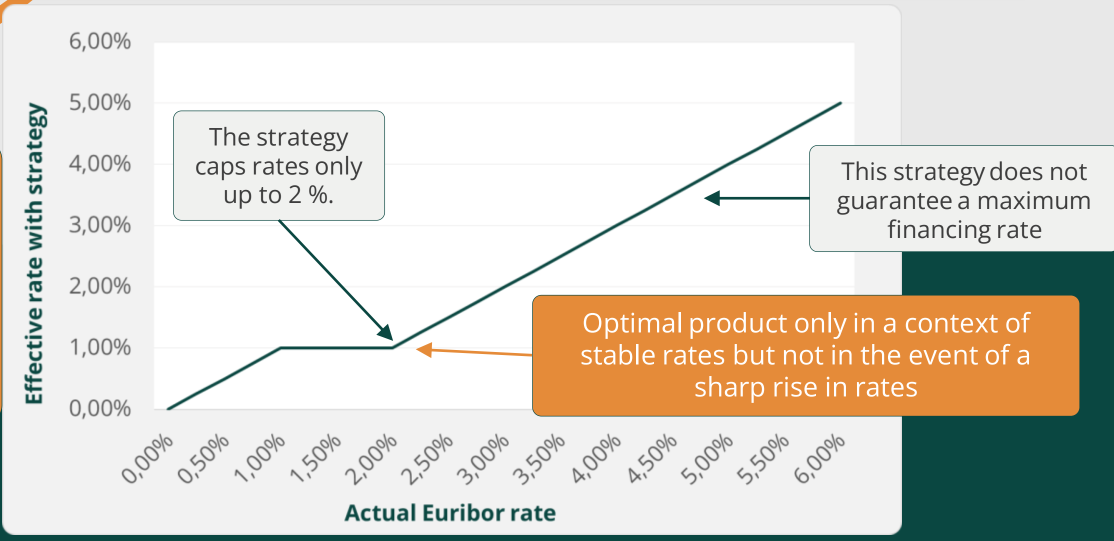
Companies that have implemented cap spread strategies with cap levels sold at 2 or 3% are now finding themselves with significantly higher financial costs, sometimes without understanding the origin of this increase. For some, the losses can become unbearable.

A COMPLEX FOLLOW-UP

The visibility of financial expenses can be significantly degraded with this type of strategy. The accounting consequences are often poorly explained and poorly understood. Restructuring these strategies is complex and very costly without expert support.

Effective financing rate with a cap spread of 1 % - 2 %

An objective financial expense simulation alerts to the ineffectiveness of the strategy beyond a certain Euribor level.



Optimal product only in a context of stable rates but not in the event of a sharp rise in rates

Your key contacts

Sébastien Rouzaire

Founding Partner

30 years experience in Corporate Finance and market risk management

Experience: Crédit Lyonnais Capital Markets London, Bouygues, LVMH (Trading Room Manager) and Gemplus (VP & Corporate Treasurer).

Since 2007, financial risk management advisory for companies, funds and multi-family-offices.

Master’s degree in finance from Audencia.

Solal Huard, CFA

Director

7 years experience in financial risk analysis and management

Experience: Pléiade & Cie (Asset Management), Luxcellence (Market Risk).

Since 2018 at KERIUS Finance: market risk analyst and advisor. Director since 2022.

Master's degree in market finance from Neoma Business School.

Marion Dondin

Head of Operations

4 years experience in corporate and market finance

Experience: Pyramide Conseils, Fifty Bees (Financial Audit).

Since 2020 with KERIUS Finance: market risk analyst and advisor. Head of Operations since 2023.

Master's degree in corporate finance from IAE Lyon.

Three service pillars

SINGLE OR REGULAR SERVICES

Diagnostic Advisory

- Risk analysis
- Diagnostics
- Acquisition due diligence (foreign exchange, interest rate and raw materials)

Advisory/implementation of hedging policies (foreign exchange, interest rates and commodities).

Feasibility study and implementation of central financing/hedging.

Debt management. Risk analysis and asset/liability management.

Trading *room* support

Support in hedge management: market monitoring, bank relationships and negotiations, quotations, reporting.

Support in reconciliations or disputes involving complex structured products.

Simplification of complex structured product portfolios.

Valuation of all derivatives and bonus shares, stock options/BSPCE, convertible bonds.

Customized reporting

Construction and production of :
Back-office, middle-office and management accounting/performance dashboards.
Customized IFRS reports and documentation.
Decision support tools and debt management reporting (currency, interest rate and commodities, micro/macro hedging, all medias).

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