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Legal alert

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INTEREST RATE HEDGING IN REAL ESTATE FINANCING

Interest Rate Hedges are usually an integral part of real estate finance transactions and borrowers need to ensure that they understand the risks associated with such Interest Rate Hedges.

It is often a condition of lenders that the borrower (who usually sets up a special purpose vehicle for real estate financing) hedges interest rate risk on a part of the floating rate (LIBOR or Base rate) loan they have taken for financing real estate projects. The percentage hedging requirement can vary from project to project and from lender to lender, but often is in the range of 50% to 100%. Even if no Interest Rate Hedging is required and instead a fixed rate loan is taken by the borrower then the borrower has to ensure that they still fully understand the condition of such a loan, especially the resulting cost consequences, if any, in case the borrower is likely to repay the loan earlier than its scheduled maturity. These fixed rate loans may involve behind the scene interest rates swaps without the involvement of the borrower and can still have consequences for the borrowers in case of early repayment of the loan.

There has been a lot of scrutiny on Interest Rate Hedges especially entered into by the borrowers in the period up to 2009. Significant reduction in interest rates by the Bank of England and other central banks around the world in a short span of time from late 2007 to 2009 resulted in significant mark to market losses on many of such Interest Rate Hedges (or "Hedges" or "Swaps"). A number of such cases of Interest Rate Hedges have hit the headlines, particularly in relation to how they were sold by the banks, suitability of these hedges, the advisory role of banks, duty of care, behind the scenes back to back hedging, and potential linkages to LIBOR manipulation.

While some of these cases have exposed sharp sales practises at banks and unsuitability of some of the swaps to borrowers (which led to the disputes and settlements between the banks and borrowers), they have also highlighted the need for the borrowers to ensure that they understand the implications of hedging given the nature of their underlying businesses and objectives particularly in cases where the borrower intends to prepay a part of the loan prior to its maturity. On prepayment of the loan, any Interest Rate Hedges are to be unwound and there may be significant costs associated with the unwinding of these hedging transactions depending on the prevailing interest rates.

Given the current low interest rate environment, and the potential raising of interest rates by the Bank of England in the near future, the US FED has made 0.25% hikes in Dec 15, Dec 16 and March 17, borrowers may start to consider fixing the interest rate by doing an interest rate swap. Hedging the interest rate can protect both the lender and the borrower as it brings certainty to the interest rate costs and hence the available cash flows from the investment. This certainty means the borrower has one thing less to worry about on their investment. Below we highlight the key issues that should be considered:

- Minimum hedging percentage: It is quite likely that the lender has proposed a minimum hedging percentage based on their general practice and has not tailored it to the borrower's specific situation. For example, if the bank has insisted that 100% of the loan be hedged and the borrower plans to pre-pay a part of the loan before maturity, there is no rationale for doing a 100% hedge for the full maturity of the loan. The optimal hedging percentage and tenor of the hedge depends on the borrower's underlying business and cash flows, borrower's objectives and risk tolerance and this should be reflected in any hedge undertaking.

- Timing of hedge: Usually lenders insist that hedging needs to be done within a certain time-frame from the date of approval of the loan. It is important that the hedge is completed when the loan has been disbursed, or, if done prior to the disbursement, there is no uncertainty whatsoever on the amount of loan that will be disbursed and its repayment schedule once disbursed. This will ensure that borrowers do not enter into unwanted hedges in situations when loans are not disbursed, or not required for some reasons such as a property deal falling through, leaving them to substantial risks (of potential losses or gains) on unwinding of hedges.
- Type of hedge: Interest Rate Swap, Cap, and Collar are the main hedging instruments. The choice of hedge instruments should be aligned to the underlying business, and prevailing market conditions. An Interest Rate Swap fixes the interest costs and has the advantage of known costs, however it is not flexible if the loan is to be repaid prematurely. Fixing the interest rate also has the disadvantage of high opportunity cost in the case where interest rates remain low or become even lower. The Cap is an insurance-like instrument and protects the borrowers from interest rates going above a chosen level and lets borrowers take advantage of prevailing lower rates in case rates do not increase. The Cap can also be unwound at no further costs in case the borrower decides to pay the loan prematurely. However, a premium is required to be paid for a Cap hedge. The Collar hedge is a hybrid between an Interest Rate Swap and a Cap hedge and fixes the interest rate costs between chosen boundaries for zero or small up-front cost. No complicated or exotic hedges, such as callable hedges, should be considered and hedging notionals or tenors should not exceed the underlying loan notionals or tenor.
- Optimal hedge execution: This is the single most important area where the appropriate expertise and focus from borrowers can save them substantial costs on hedge margins charged by banks. It is important to benchmark the hedge pricing provided by banks in a live setting by breaking down the price to mid-price, bid-offer spread, and adjustments to reflect credit, regulatory and other charges of banks. Where possible, hedge provider banks should be put in competition with each other. This process can help to substantially reduce the charges by banks to a fair level resulting in considerable savings to the borrower. Depending on the size of hedge and volatility in the underlying markets, selection of hedge execution time is also a relevant consideration to achieve optimal execution.
- Pre and Post Hedge Execution Documentation, Reporting and Monitoring: A borrower has to sign an ISDA Master agreement with hedging banks prior to the hedge execution. The negotiation of an ISDA document can take time and appropriate legal assistance should be sought by the borrower to ensure that the agreement is fair and conforms to market standard. The borrower will also need to get an LEI (Legal Entity Identifier) or a unique temporary or definitive code identifying them for the purposes of their obligations post trade execution under the European Market Infrastructure Regulation (EMIR).

Once the hedge has been executed, a trade confirmation is issued by the bank and signed by both parties. The borrower should ensure that the trade confirmation reflects the terms of actual trade and in case of any discrepancies, the same are resolved immediately.

Post hedging, it is also important for the borrower to monitor the hedge and its valuation periodically to ensure that the hedge still serves their objectives. Any changes in circumstances such as prepayment of loan, refinancing of loan or sale of underlying asset could affect the hedging and may necessitate the restructuring or termination of hedging with cost/gain consequences. Before any hedge unwinding or restructuring is carried out, a full rationale should be established and its execution carried out optimally and cost effectively.

Finally, although banks as hedge providers can provide a lot of information to the borrowers on hedging, they do not advise on the suitability or appropriateness of hedging deals. Hedging is a specialist area, and if required, the borrowers should seek advice from independent Financial Conduct Authority (FCA) authorised hedging advisers to ensure optimal hedge selection, hedge execution and pre/post hedge management. This will also help the borrower avoid any pitfalls faced by a number of both small and large borrowers all over the world, which have resulted in the purchase of inappropriate hedging products by borrowers, mis-selling of swap products, or excessive profit taking by banks on such products.

By: Ajoy Bose-Mallick (Real Estate Finance Partner, Maples Teesdale LLP) and JP Agrawal, (Managing Director, Derivatives Value Advisors Ltd)