Guidelines for Interest Rate Hedging in European Commercial Real Estate Finance Transactions

Commercial Real Estate Finance Council Europe®

Contents

1. Introduction

In 2012 the Commercial Real Estate Finance Council Europe ("**CREFC Europe**") established a working group (the "**Hedging Working Group**") to study and report on interest rate hedging practices used in European commercial real estate finance transactions, with the ultimate objective of formulating certain practice guidelines that would be useful to market participants as liquidity returned to the commercial real estate finance market and the subject matter became of more practical importance.

The Hedging Working Group was chaired by Mark Battistoni of Chatham Financial and co-chaired by Partha Pal.

The members of the Hedging Working Group completed their deliberations during the early part of 2013, and their conclusions are summarised in this document.

The Hedging Working Group focussed on the following areas:

- the need for interest rate hedging in commercial real estate ("**CRE**") finance transactions;
- the structural alternatives typically available to achieve such hedging;
- the relevant considerations in structuring interest rate hedging in CRE finance transactions; and
- certain practice guidelines that could potentially be relevant to market participants in structuring future transactions.

Consideration was also given to the implications of the European Market Infrastructure Regulation ("**EMIR**") on hedging in CRE finance transactions, as a distinct topic. While the full implications of EMIR are beyond the scope of this document, it is clear that it will, impact on all users of OTC derivatives and so will affect interest rate hedging arrangements used in the context of CRE finance transactions. We have included an over-view of EMIR as a schedule to this document.

The discussions of the Hedging Working Group were wide ranging, representing the view of a number of the sub-sectors of the CRE finance market. This document represents an attempt to present those views in a coherent manner and has been reviewed and commented on by each member of the Hedging Working Group prior to its release more generally. It has also been reviewed by the CREFC Europe leadership team.

2. The Need for Interest Rate Hedging in European CRE Finance Transactions

CRE finance arrangements (by which we mean, in broad terms, loans made to an owner of an income generating property or properties in respect of which debt service payments are made solely or substantially from the cash-flow generated by them) typically fall into two categories: those that require the borrower to pay interest at a floating rate (typically one, three, or six month LIBOR / EURIBOR as the basis plus a margin) ("**Floating Rate Loans**") and those that require the borrower to pay interest at a fixed rate ("**Fixed Rate Loans**").

A borrower owning commercial real estate that borrows a Floating Rate Loan will have a well-defined interest rate exposure: if the interest rate basis applicable to the Floating Rate Loan increases, the borrower's ability to continue making payments of interest and repayments of principal may be compromised because its income – rent from the properties and disposal or refinancing proceeds relating to them – is not responsive to such increases in interest rates. The borrower may be able to continue making debt service payments in some scenarios (for example, if it has surplus rental income relative to the amount of debt-service payments or if there is some form of sponsor guarantee) but, ultimately, it has an exposure which, without management, may lead to financial distress.

The Hedging Working Group recognised that it was counterintuitive that the commercial and documentation-related implications of interest rate hedging were not isolated to Floating-Rate Loans. A borrower owning commercial real estate which borrows using a Fixed Rate Loan will not, by definition, be exposed to the risk of interest rates increasing in the same way as the borrower of a Floating Rate Loan and so may not "require" interest rate hedging in the same way as a means of managing potential financial distress. However, such a borrower may have a more subtle set of risk exposures because of interest rate movements or counterparty risk – very similar exposures to that of a borrower of a Floating Fate Loan with a separate hedging contract, but in some ways, more complex. For this reason, especially given the proliferation of Fixed Rate Loans in the current market, the Hedging Working Group spent a meaningful amount of time examining the operation of interest rate hedging in the context of Fixed Rate Loans.

Taking one important example in the case of Fixed Rate Loans, if a lender funds itself through floating rate borrowings (which would typically be the case for a bank funding a loan on an "on-balance sheet" basis or a CMBS issuer which issues floating rate notes, which would, in either case, be referenced to LIBOR or EURIBOR), the lender would itself tend to have hedging arrangements in place. Any costs of these hedging arrangements would be passed onto the borrower to the extent agreed between them.

Fixed Rate Loan structures typically reference a "Related Funding Arrangement" or, where the arrangement was between two desks at the same bank, a "Notional Hedge Transaction". The borrower is not party to such hedging arrangements and, though it is not helpful to generalise, often has limited control over or visibility of their terms. From a borrower's perspective these arrangements give rise to a serious consideration: an early termination of a lender-level hedge for whatever reason could result in early termination payments payable by the lender to the hedge provider, which the lender would seek to pass onto the borrower in full (on the rationale that the hedge was entered into for the ultimate benefit of the borrower, since the lender was able to provide the borrower with a Fixed Rate Loan). This feature of otherwise attractive Fixed Rate Loans has caused discontent among borrowers, particularly if an early termination payment has been required because, for example, there has been an insolvency event at the level of the lender or the hedge provider. Borrowers, with some justification, have queried the fairness of such an outcome, given that the causative event had nothing to do with them. Of course, some lenders are better at providing visibility than others on the terms of the Related Funding Arrangement or Notional Hedge Transaction, and where this is the case, the borrower has an opportunity to negotiate the early termination scenarios, so that they are satisfactory to both borrowers and lenders.

Other types of Fixed Rate Loans without such hedging arrangements are prevalent in non-bank and non-CMBS structures, for example where the lender is a pension provider or an insurance company, which is seeking to match long term assets with long-dated liabilities. These loans often have complex terms relating to prepayments which, from the borrower's perspective, impose a cost when the borrower seeks to prepay the loan or otherwise defaults and early repayment is required. The complexity of these provisions sometimes make it hard to compare the costs of a prepayment or early repayment with similar costs arising in the context of a more conventional Fixed Rate Loan with a hedging arrangement of the type described above. However, they generally do not impose on the borrowers early termination costs relating to lender or hedge provider distress.

Thus, most CRE finance transactions require interest rate hedging to mitigate the risk of the interest rate basis increasing either at the level of the borrower (in the context of Floating Rate Loans) or at the level of the lender (in the context of Fixed Rate Loans) with the borrower having an obligation to make payments in relation to it. The Hedging Working Group was of the view that the need for interest rate hedging will continue, irrespective of whether Fixed Rate Loans or Floating Rate Loans are used, though there will be certain structural changes as a result of a decline in bank lending volumes and CMBS issuance and increases in lending by pension providers, insurance companies or debt funds, that could have a bearing on how transaction participants approach interest rate hedging. There will likely also be more limited use made of certain hedging strategies. The most cited example would be any swap or similar arrangement with a maturity exceeding the maturity of the loan, as the consequences of these arrangements have been exposed during the previous credit cycle.

It was pointed out by Hedging Working Group members serving in the capacity of hedge providers that they were, in principle, willing and able to consider a variety of hedging approaches. Some of these would limit the extent to which a hedge – even a long-dated swap, in the extreme – could become a liability for the borrower during its term. The concept of limiting the potential hedging liabilities to a known, worst-case amount was seen as attractive; however, there would typically be some additional cost associated with it, and this would have to be agreed on a case by case basis.

3. The Structural Alternatives Typically Available

There are a variety of hedging products that may be used to hedge interest rate exposure of a borrower or lender, as the case may be, in the context of CRE finance transactions. These were considered by the Hedging Working Group. The most basic of these are:

- **an interest rate swap**: under such an arrangement, in the context of a Floating Rate Loan, a borrower would enter into a contract with a swap provider (described as the "**counterparty**") under which the borrower would be liable to pay the counterparty a "fixed" payment (calculated by applying a fixed rate to a notional amount) and the counterparty would be liable to pay the borrower a "floating" payment (calculated by applying a floating rate to the same notional amount). Thus, if the interest rate basis increased, the fixed payment from the borrower to the counterparty would not increase but the floating payment from the counterparty to the borrower would. The net payment would thus be in favour of the borrower, offsetting its increased liability in respect of the Floating Rate Loan. In the context of a Fixed Rate Loan, the lender (which typically funded itself through borrowing floating rate debt) would enter into a contract with a counterparty under which the lender would be liable to pay the counterparty a fixed payment (based on what it expects to receive from the borrower in respect of the Fixed Rate Loan) and the counterparty would be liable to pay the lender a floating payment, the fixed and floating payments being calculated following the same methodology as in the context of a Floating Rate Loan and being paid on a net basis.

  Under this arrangement, both the borrower and the counterparty would take the risk that the other could fail to make the payment owed by it (in more technical language, there is bilateral counterparty credit risk) and either could owe the other an early termination payment in the event that the termination of the interest rate swap occurs before it is scheduled, depending on which party was the net payer or the net payee;

- **an interest rate cap**: under such an arrangement, in the context of a Floating Rate Loan, the borrower would enter into a contract with a counterparty under which the borrower would be liable to pay the counterparty a one-off upfront fixed payment (essentially a premium) and the counterparty would be liable to pay the borrower floating payments if interest rates exceeded a specified threshold level. Thus, under the cap, unless the borrower arranges with the counterparty to defer the payment of the up-front premium, the counterparty does not take any ongoing risk of payment default by the borrower (or in more technical language, there is unilateral counterparty risk with the beneficiary[1] of the cap, but not the counterparty, being exposed) and, to that extent, there is an advantage to a counterparty of this structure.

  Alternatively, it is possible for the borrower to borrow the amount of the up-front premium from the same or another lender, or indeed an affiliate of a lender such as its derivatives trading entity / desk. The borrower would then have to ensure that the interest on and repayment of this loan could be paid using the net cash flow available to it from the properties that it owned and after repayment of the main facility. Both lenders would have to ensure that they were content with both their rights against the borrower and their rights against other lenders in the borrower's capital structure. In this scenario the CRE lender would need to be aware of the seniority of this "extra" slice of debt. In some ways any such debt would be nearly identical to the liabilities imposed by other hedging strategies such as swaps, but in other ways it is different. Accordingly, the CRE lender might also require some adjustments be made to the terms of the main facility, especially if any hedging payments were to be senior to the CRE loan.

  The great advantage of the cap structure, from the perspective of the borrower, is that there is no obligation to make early termination payments to the provider of the cap, though it is always possible that where the up-front premium is funded by a loan, there could be prepayment amounts payable to the lender. The drawback is that borrowers need to be extra vigilant about the creditworthiness of the financial institution providing the cap.

[1] By "beneficiary", as used in this document generally, we mean either the borrower (where the borrower enters into the hedging arrangement) or the lender (where the lender enters into the hedging arrangement).

This is because if the counterparty defaults, the borrower will have still paid the premium and will only have an unsecured claim to recover it (absent any collateral). However, it will still have to meet its obligations in relation to any amounts borrowed by it to fund the up-front premium and will need to obtain an equivalent hedge from an alternative provider on then current market terms which will likely require the funding of another one-off upfront fixed payment; and

- **an interest rate swaption**: under such an arrangement, in the context of a Floating Rate Loan, the borrower would enter into a contract with a counterparty under which it would have an option to enter into an interest rate swap at some future point in time. In the context of a Fixed Rate Loan, the same concept would operate, but would apply between the lender and the counterparty. Again, in practice, the swaption approach was employed rather infrequently for directly hedging interest exposure during the loan term after the loan had closed. It was more frequently used for purposes of pre-hedging (i.e. locking in the interest rate of a loan before the loan was actually closed), after which another instrument provided the hedge during the loan term itself.

The Hedging Working Group was of the view that the basic structural alternatives for interest rate hedging in the context of CRE finance transactions would remain unchanged in the post credit crisis environment though the possibility of an increased use of interest rate caps (in order to avoid early termination payments and/or the potential for clearing the hedging arrangement because of the requirements of EMIR – as further described in Schedule 1) should be recognised.

Another structural change that the Hedging Working Group recognised was that CRE lenders and hedging counterparties may be different entities, and that some lenders – for a variety of reasons, including regulatory ones - may no longer provide certain hedging services. By the same token, some active hedging counterparties are not, and are not likely to become, active in CRE lending.

As a final point in relation to this area, the Hedging Working Group recognised that in certain cases it may be appropriate not to require hedging arrangements to be put in place at the same time as a lending arrangement, but rather defer the requirement to enter into such arrangements on pre-agreed terms and/or with a pre-agreed counterparty if a trigger event occurred (for example, a certain interest cover test would be close to being breached). While this was viewed as practical, the Hedging Working Group recognised both the increased interest rate risk and execution risk of this (if, for example, when the hedging arrangement was required, the proposed counterparty was subject to financial distress or if interest rate rose very rapidly).

4. The Relevant Structuring Considerations

According to the deliberations of the Hedging Working Group, structuring considerations for any hedging arrangement in the context of a CRE financing transaction may be divided into two broad categories:

- those between the counterparty and the beneficiary of the hedging arrangement (the "**Inter-Party Considerations**"); and

- those between the counterparty and the other creditors of the beneficiary of the hedging arrangements (the "**Inter-Creditor Considerations**")

In order to appreciate both the Inter-Party Considerations and the Inter-Creditor Considerations more fully, it is necessary to comprehend the basic nature of a commercial real estate financing. The key feature of such financing is that a borrower has only one type of valuable asset: the commercial real estate asset or assets it owns. This asset has to sustain a number of claims: the claims of a senior lender, the claims of any hedging arrangement entered into in relation to the senior loan; the claims of any mezzanine lender; the claims of any hedging arrangement entered into in relation to any mezzanine loan; the claim of the equity provider and any service providers (such as asset managers, property managers, insurance providers and so on) as well as, possibly, the claims of any lender who finances an upfront hedge premium. Thus, while such a loan is typically "full recourse" to the borrower, in reality recourse is limited to the cash-flow generated by the relevant commercial real estate, as the equity sponsor generally has no obligation to provide support beyond its initial equity consideration.

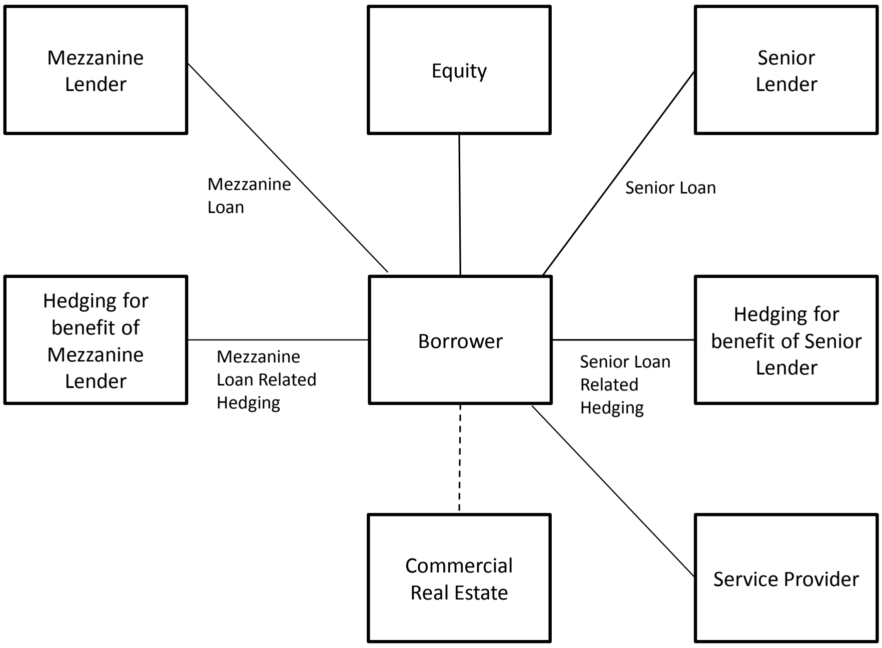

Figure 1: Floating Rate Loan – Claims on Borrower

In the context of Floating Rate Loans, all claims, including the claims of the counterparty, lie directly against the borrower and so must be paid by the borrower alone using its real estate assets and the cash flow generated by them.

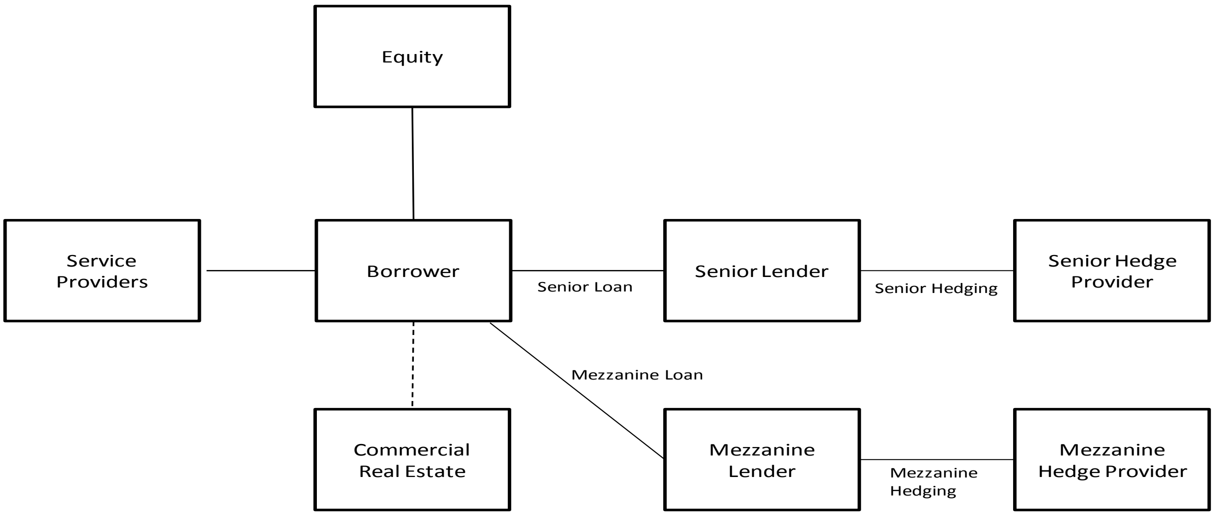

Figure 2: Fixed Rate Loan – Claims on Lender

In the context of a Fixed Rate Loan, the claims of the hedge providers (again often through Related Funding Arrangements or Notional Hedge Transactions and, most significantly, in relation to early termination payments) will lie directly against the lenders rather than against the borrower. Thus, the recourse of the counterparty could, in theory, be to all the assets of the lender, as opposed to its exposure to the borrower alone. However, in some cases, the lender will itself be a vehicle (with exposure to one or more borrowers, as is the case for a CMBS issuer or a lending vehicle set up by the sponsors of a real estate debt fund) and in other cases, the recourse of the hedge provider may be expressly limited to the cash flow obtained from a particular borrower, and paid pursuant to a particular priority of payments at the level of the lender or possibly pursuant to some form of liquidity facility, in the context of CMBS transactions.[2]

Thus, from the perspective of the counterparty, the key proposition is that, in the context of a CRE financing, it will generally be exposed to "asset risk" on the relevant commercial real estate and therefore ought to consider both the quality of the asset and the rights it has in terms of value extraction, both by reference to the competing rights that the borrower has but also by reference to the competing rights other creditors have. As described further below, this proposition formed the basis of a number of the guiding principles formulated by the Hedging Working Group.

With respect to Inter-Party Considerations, the Hedging Working Group was of the view that the following were the most relevant:

- the payment obligations of the counterparty and the payment obligations of the beneficiary of the hedging arrangement;
- how each party will meet its payment obligations to the other;
- the existence and maintenance of any hedge counterparty ratings provisions, including the coherence of these provisions in each set of documents (i.e. ISDA governing hedge and facility agreement);
- the performance obligations of both the counterparty and the borrower or lender, as the case may be (including the reporting obligations owed by each);
- what are the circumstances under which the hedging arrangement may be terminated before its scheduled date; and
- the consequences of early termination, particularly in relation to any early termination payments.

The other Inter-Party Consideration that warranted consideration was the consequences of deterioration in the credit quality of the counterparty and ensuring that structuring arrangements are in place to protect against this, the most basic structuring arrangement being either replacement or collateralisation. This was considered by the Hedging Working Group as a particularly relevant topic, given counterparty defaults after the on-set of the financial crisis, as well as the fact that quite often documents relating to the provision and custody of collateral were not put in place in a timely manner.

With respect to Inter-Creditor Considerations, these too may be divided into fairly well identified categories, according to the Hedging Working Group:

- the events of default in respect of the lending arrangements (the "**Lending Events of Default**");
- the consequences, in terms of enforcement options and control over the enforcement process, if a Lending Event of Default occurs ("**Enforcement**");
- the ranking of creditors following the occurrence of an event of default ("**Ranking**");

[2] It should be noted that, in practice, CMBS liquidity facilities were not always available to pay hedging costs.

- the pre-default remedies that are provided for and how they impact upon the counterparty ("**Pre Default Remedies**"); and

- the early termination of the hedging and how these relate to the other elements described above ("**Early Hedging Termination**").

These are complex matters and each was considered in turn by the Hedging Working Group.

5. Lending Events of Default

The Hedging Working Group recognised that prior to the on-set of the financial crisis, the Lending Events of Default in CRE finance transactions were reasonably well defined: payment default, performance default, financial covenant breach, and insolvency were all generally found in CRE finance transaction documents. What was not always rigorously analysed, or consistently approached, was the impact that the occurrence of a Lending Event of Default would have on a related hedging arrangement.

The Hedging Working Group recognised that there is a logic in a Lending Event of Default giving rise to an early termination of the related hedging arrangements. However, this would ultimately expose the lenders not just to asset risk (on the commercial real estate) but also to the risk that interest rates could rise following the occurrence of a Lending Event of Default, leaving the lender doubly exposed[3]. Thus, there was equal logic in the hedging arrangements remaining in place notwithstanding the occurrence of a Lending Event of Default, particularly in the context of lender-level hedges where the lender continued to make the payments due to the counterparty under the hedging arrangements, notwithstanding the occurrence of a Lending Event of Default. This was a topic of some sensitivity, however, from the perspective of the counterparty and the argument was made that material Lending Events of Default (such as non-payment by the borrower or the borrower's insolvency) should result in the counterparty having a right of early termination as well, even though the lender might be able to keep the hedging arrangement in place by making the necessary payments itself.

It was generally acknowledged that acceleration under the lending arrangement should trigger early termination under the hedging arrangement, though settling any early termination payment would have to be deferred until the enforcement process had run its course and value had been realised from the relevant real estate assets.

Finally, it was acknowledged by the Hedging Working Group that trying to formulate any guidance that was too prescriptive could be difficult. In some actual situations, if there is a Lending Event of Default the lenders could consider it attractive to terminate the hedging arrangements, as this may have, in certain interest rate environments, resulted in their being more available cash-flow to repay the lenders. Given that the hedging arrangements ultimately exists to benefit the lenders, there is logic in the argument that the lenders should have the final say in determining whether the occurrence of a Lender Event of Default should result in the early termination of the hedging arrangement, subject to "automatic" early termination in some particularly serious cases and in the event of loan acceleration. This could lead to conflicts between the Lender and the counterparty, with the counterparty facing credit risk in a situation it may wish to exit.

[3] It should be recognised that even in the context of Floating Rate Loans, the hedging arrangement between the borrower and the counterparty ultimately benefits the lender and so termination of the hedging arrangements impacts upon the lender.

6. Enforcement

The Hedging Working Group recognised that following the occurrence of a Lending Event of Default the critical question for all transaction participants was how, and by whom, an enforcement strategy should be devised and implemented. Prior to the credit crisis, the guiding principle was that this would be in the hands of the senior lender subject to subordinated lenders having certain protective rights, such as the right to make cure payments, buy-out the senior loan or take enforcement action if the senior lender fails to do so within a specified time period and provided there was sufficient value coverage. The Hedging Working Group regarded it as unusual, based on historic evidence, that a counterparty (whether a third party or an affiliate of the lender) would have any rights in respect of enforcement action. Yet, logically, as a counterparty would be a creditor, consideration should be given to whether this was appropriate, particularly where the hedging arrangements continues to be operative notwithstanding the occurrence of a Lending Event of Default and may have a legitimate interest in these matters. The extent of the counterparty's control in these circumstances could be determined by reference to the mark-to-market value of the hedging arrangement at the relevant time, relative to the principal amount outstanding owed under the lending arrangements to other lenders as well as the counterparty’s ranking in the structure and the value coverage in respect of the counterparty's and all lender's liabilities.

7. Ranking

The Hedging Working Group recognised that, prior to the financial crisis, counterparties, either at the level of the borrower or at the level of the lender, would typically rank senior to or at least *pari passu* with the lender that ultimately benefitted from it providing a hedging arrangement.

Achieving a position of super-seniority was consistent with the counterparties focussing less on due diligence or control rights, either against the borrower or lenders. Where the lender and the counterparty were the same entity, or different entities within the same corporate group, the lender would typically be comfortable with the counterparty ranking super senior and the counterparty would be comfortable with the lender's diligence and control approaches. However, where the counterparty and lender were different institutions, the lender could well view as less attractive the fact that it ranked behind the counterparty and the counterparty would take the opposite view. Where the counterparty ranked *pari passu* with the lender, there was an incentive for it to undertake its own due diligence and assert its own control rights, thus making the execution and enforcement process more complicated. It was recognised that in some instances this dynamic could effectively leave certain borrowers no alternative but to purchase a cap with an up-front premium payment to satisfy any hedging requirement of the financing.

There would be no one-size-fits-all solution to ranking – it was necessary for both the lenders and the counterparties to consider a variety of factors, though a logical starting point was whether they were both the same or affiliated entities, or whether they were unrelated.

8. Pre Default Remedies

In the pre-financial crisis world, CRE finance transactions often contained structural features which were designed to protect the position of a senior lender at the expense of a mezzanine lender in the event that there was evidence of financial distress which fell short of a Lending Event of Default. The Hedging Working Group considered whether it might be appropriate for there to be any refinements to such provisions to benefit counterparties. For example, consideration was given to whether, if a particular transaction had an intermediate interest cover ratio and related cash sweep, the cash sweep should be used only for the purposes of paying down senior debt or whether it should be used to pay down senior debt and any related hedge early termination costs on a pro-rata basis.

The Hedging Working Group also considered it likely that there would continue to be some form of requirement for a partial termination (or "unwind") of hedging arrangements on partial prepayment of loans, so that the risks of over-hedging were avoided.

9. Early Hedging Termination

Finally, the Hedging Working Group considered whether there were any circumstances under which it is justifiable for an interest rate hedging arrangement to be terminated earlier than the related lending arrangement. It was recognised that maintaining the stability of the position of the lenders necessitated that such early termination would not, generally, be appropriate though, in the context of a Fixed Rate Loan, insolvency of the lender should allow early termination of the relevant hedging arrangement. There were other early termination events that were regarded as reasonably standard, even in the context of lender level hedges. These included illegality and force majeure, as well as tax events.

One particular additional early termination event was considered by the Hedging Working Group: this was whether, in the context of a situation in which the lender and the hedge counterparty were the same, or affiliated, entities if the lender sold down its position (in part of in whole) to a third party, whether the hedging arrangement should be subject to early termination. In broad terms it is not standard for such an event to trigger economic consequences for a borrower to the loan. For example, a hedge counterparty would ordinarily be expected to replace itself at no cost to the borrower in the event of any transfer, irrespective of the participation of any affiliated lender in the financing.

In the context of the same situation with a Fixed Rate Loan, this should be a matter of indifference to a borrower, though it is possible to conceive of borrowers being disinclined to make any early termination payments in this scenario. In the context of a Floating Rate Loan it seems that the borrower could find itself at a disadvantage if its hedging arrangement was terminated early and then there was a material increase in the interest rate basis, or an unscheduled cash event even if the interest rate basis were to continue on grounds of economic equivalence. In any event, this was a situation where the Hedging Working Group recognised the possibility that there would be a divergence in views between different sides of a hedging arrangement.

10. Practice Guidelines

It should be made clear that the Hedging Working Group, in approaching its task, did not aspire to formulate practice guidelines that would be applicable in all transactional contexts. Rather, the approach was to identify areas which transaction participants should give consideration to. With this in mind, the following general principles were formulated:

- consideration should be given, at the outset of a CRE finance transaction, to whether interest rate hedging is necessary or appropriate (this may not always be the case and it should be recognised that interest rate hedging ultimately seeks to protect the lenders against default risk). Such consideration should come from both the borrower and the lenders and should be articulated at the term sheet stage. The view of the lenders should, however, ultimately prevail;

- where interest rate hedging is appropriate, consideration should be given to the product used and the hedging strategy. Linking hedging requirements or specific characteristics of acceptable hedging strategies to financial covenants is an approach that satisfies some measure of objectivity, but a range of practices by lenders would be appropriate. Again, there is no universal solution;

- in the post financial crisis environment, lenders and counterparties are more likely than in the past to be different entities. When hedging strategies involving credit risk such as swaps or deferred premium caps are desired in these situations, it should be recognised that the underwriting of credit risk in respect of a hedge by third party banks may not be an easy or efficient process on many (especially smaller) transactions. The derivatives desks of lending banks, where they are the hedge counterparties, should continue to draw comfort from the underwriting by their affiliated lending desks in order to understand the credit risk;

- counterparties should recognise that they are taking "asset risk" and so should be included in, and benefit from, all due diligence undertaken in relation to the assets that are the subject matter of the financing;

- both beneficiaries and counterparties should recognise, and take steps to manage, counterparty credit exposure each has to the other in the context of a hedging arrangements;

- the operation of the hedging arrangement should be transparent to all concerned, particularly in relation to any unusual features which might be relevant to future debt investors. Certain details might not be appropriate for wider circulation, such as the specific fees charged on the transaction, but in general the benefits of higher levels of disclosure of derivatives transactions tied to financings are seen to generally outweigh any detriment. The lack of transparency was regarded as a shortcoming of, in particular, CMBS transactions and should be remedied, both in relation to initial disclosure and ongoing disclosure;

- connected with disclosure, specific care should be taken in relation to features which heighten risk such as long-dated hedging or mismatches in hedging coverage;

- hedging arrangements should be fully documented at the time of the CRE finance transactions and should not follow after the event;

- hedging arrangements need to be stable and not subject to premature termination. The early termination scenarios should, therefore, be limited and in this respect the CMBS approach provides a helpful precedent. Early termination scenarios must be suitably disclosed;

- in the event of financial distress at the level of a borrower, it is appropriate to consider giving the counterparty some level of influence and control over an enforcement depending on its ranking and the early termination regime and protective rights against other creditors. The extent of the counterparty's influence on the enforcement process relative to other creditors should be based on the mark to market value of the hedging arrangement;

- the hedge counterparty should benefit in the security interest granted for the benefit of the lenders if and insofar as possible; and

- if hedging is arranged purely between a lender and a counterparty, a borrower should not be prejudiced by financial distress at the level of the lender or the counterparty and its implications on the hedging arrangements, without full transparency of the implications of this.

It is stressed that these are not answers but rather ways to analyse how particular transactions should be structured, the ultimate results varying based on numerous factors such as the nature of the borrower / sponsor; the nature of the assets; the leverage levels; the nature of the lenders; and the nature of the counterparties.

Finally, in addition to the transactional considerations described above, the Hedging Working Group also gave some consideration to the impact of the EMIR on hedging arrangements on CRE finance transactions. The deliberations on EMIR are set out in Schedule 1.

11. Conclusion

As is apparent from this document, the subject matter considered by the Hedging Working Group is both extensive and complicated. The pre credit crisis transactions undoubtedly revealed matters that warranted improvement; the post credit crisis transactions, and the structural changes in the CRE finance market will give rise to further challenges in due course. However, it is hoped that the work of the Hedging Working Group will be some help to transaction participants going forward.

Schedule 1
EMIR

EMIR is the EU's implementation of the G20 mandate, addressing the risks of OTC derivatives. It became law in August 2012 and, as a regulation, is directly applicable in all Member States of the EU. Technical Standards relating to EMIR have been passed by the European Securities and Markets Authority ("**ESMA**") and these are gradually coming into force.

EMIR impacts on all users of OTC derivatives to a greater or lesser extent. It imposes three key requirements:

- a central clearing requirement (requiring OTC derivatives to be cleared through a "central clearing counterparty" or CCP);
- a reporting requirement (requiring users of OTC derivatives to report information about them to a repository of information known as a "trade repository"); and
- a risk management requirement (requiring users of OTC derivatives to manage risks relating to them).

The degree to which the clearing obligation will impact hedging transactions in CRE finance transactions depends upon whether real estate companies and their special purpose entities are considered "non-financial" and therefore eligible for clearing and collateral exemptions. However, even where the central clearing obligation does not apply, EMIR will impose obligations in relation to transaction reporting and risk management.

EMIR defines Non-financial counterparties (NFCs) as any entities that are not financial counterparties, a category that includes alternative investment funds as defined in the Alternative Investment Fund Directive (AIFMD).

Real estate funds, for example, will generally be considered alternative investment funds and will therefore be financial counterparties subject to mandatory clearing and collateral requirements. Their SPV's, however, may be distinguished from the fund and be eligible as non-financial counterparties, permitting any hedging transactions done at the SPV level to remain bilaterally negotiated. Clarity around the categorisation of such SPV's has still not been forthcoming.

Because the commercial real estate borrower generally does not have access to the types of highly liquid collateral that would be required by central counterparties, if they are subject to the clearing and collateral requirements under EMIR, they will need to consider alternative risk management products that do not require margin, such as caps, and this may provide a justification for using the cap structure.