

Interest Rate Hedging for Real Estate Finance Transactions

Meritas

Presented by:

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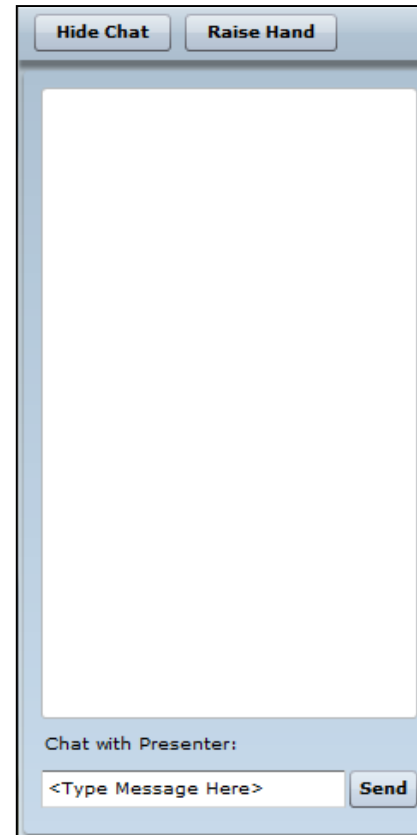
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Context

- ISDA
- Various Asset Classes (IRD, CDS, Equity, FX, Energy, Structured Products and Other)
- Interest Rate Derivatives
 - Average IRD Daily Notional Vol. \$543.0 billion*
 - Average IRD Trade Size \$133.6 million*
 - IRD \$435 trillion in outstanding notional***
 - Approximately 67.1% of IRD notional cleared ***
 - IRD with non-financial not cleared = \$9 trillion***
- Fractured Market

* ISDA Swaps Info Fourth Quarter 2015 Review

** ISDA The Value of Derivatives 2014. Gross Market Value is about 0.2% to 0.3% of Notional.

*** As of June 2015. ISDA Research Note, Derivatives Market Analysis: Interest Rate Derivatives – January 2016

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Overview – Narrow Focus

- **Hedging**
- **Real Estate Debt Finance Transactions**
- **Single Currency**
- **Floating for Fixed**
- **Swaps vs. Caps**

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Swaps vs. Caps

- **Swap is an exchange of cash flows**
- **Cap may be thought of as “insurance” against interest rate spikes**
- **Paid up front by Party B**
- **When negotiating a cap Party B’s counsel should be reviewing the documents to minimize the chances of termination**

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Description of Documents

- **Master Agreement**
- **Schedule**
 - Purpose is to amend provisions of the Master Agreement and make various elections
- **Confirmation**
 - Purpose is to detail the basic business terms for a single trade
- **Long Form Confirmation**
- **Credit Support Documentation**

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Description of Documents

- **2006 ISDA Definitions**
- **ISDA Protocols**
 - A protocol is a multilateral contractual amendment mechanism which has been used to address changes to ISDA standard contracts
 - ISDA August 2012 DF Protocol
 - ISDA March 2013 DF Protocol
 - 2002 Master Agreement Protocol - closed

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Reviewing the Documentation – Bid Package?

- Many companies rely on third-party providers to bid out their swaps and caps
- Counsel should review the bid package before it goes out to bid

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Reviewing the Documentation – Master Agreement

- 1992 Master Agreement vs. 2002 Master Agreement
 - 2002 Close-out Amount vs. Market Quotation and Loss (1992)
 - Set-off
 - Force Majeure Termination Event
 - Interest and Compensation
 - Events of Default

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2002 ISDA Master Agreement

- ISDA Master is a bilateral credit agreement
 - Obligation to make payments dependent on no Event of Default or Potential Event of Default
 - Both parties may owe a net amount to the other
 - Netting of Payments – same day, same currency & same transaction
 - Payments on Early Termination
 - Close-out Netting
 - Pre-Estimate of loss and not a penalty

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2002 ISDA Master Agreement

- Indemnity by Defaulting Party to other party
- No Transfers without consent of other party except for Early Termination Amount owed by a Defaulting Party
- Both parties may enforce remedies

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Reviewing the Documentation – Master Agreement

- Section 1 – Interpretation
- Section 2 – Obligations
- Section 3 – Representations
- Section 4 – Agreements
- Section 5 – Events of Default and Termination Events
- Section 6 – Early Termination; Close-out Netting
- Section 7 – Transfer

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Reviewing the Documentation – Master Agreement

- Section 8 – Contractual Currency
- Section 9 – Miscellaneous
- Section 10 – Offices; Multibranch Parties
- Section 11 – Expenses
- Section 12 – Notices
- Section 13 – Governing Law and Jurisdiction
- Section 14 - Definitions

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Reviewing the Documentation - Schedule

- Part 1 – Termination Provisions
- Part 2 – Tax Representations
- Part 3 – Agreement to Deliver Documents
- Part 4 – Miscellaneous
- Part 5 – Other Provisions

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Reviewing the Documentation - Confirmation

- Basic terms of the Loan Documents should be reflected in the Confirmation
 - notional amount(s)
 - fixed and floating rates
 - interest rate accrual periods
 - business days and business day convention
 - payment dates
 - termination date
 - payment instructions
- Downgrade provisions from Loan Agreement?

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Regulatory Regime and Dodd-Frank

- The US Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) passed in July 2010
- EU Regulation on OTC Derivatives, CCPs and Trade Repositories – European Market Infrastructure Regulation (EMIR) published July 2012
- EU Bail-In legislation for Article 55 of Directive 2014/59/EU of the European Parliament.
 - <http://lsta.org/uploads/DocumentModel/1972/file/lma-lsta-brrd-statement-december-2015.pdf>
 - ISDA/AFME comments on valuation of derivatives in bail-in.
<http://www2.isda.org/search?headerSearch=1&keyword=eu+bail-in>

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Dodd-Frank

- As amended by Dodd-Frank, Subsection 2(e) of the Commodity Exchange Act (CEA) makes it unlawful for a person who is not an “Eligible Contract Participant” (ECP) to enter into a swap other than on or subject to the rules of a Designated Contract Market (DCM)
- All swap guarantors must also be ECPs
- The definition of ECP is found under Subsection 1a(18) of the CEA
 - entities with a net worth of at least \$1 million that are hedging commercial risk.
 - entities with more than \$10 million in assets, or any entity guaranteed by such entity.

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Dodd-Frank

- ISDA standard “Keepwell” Terms. Provides that guarantors who are ECPs to provide a “keepwell” to other guarantors that need support to also qualify as ECPs*
- ISDA has also published a set of provisions to ensure that any guaranty included in an agreement excludes a guaranty of any swap obligations by a guarantor who is not an ECP*

* www2.isda.org/functional-areas/legal-and-documentation/standard-terms/

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Dodd-Frank

- Dodd-Frank also amended the CEA to require all swaps to be cleared through a regulated clearing house (a “derivatives clearing organization”) if the CFTC has determined that category of swaps should be cleared
- CFTC has applied the clearing requirement to interest rate swaps

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Dodd-Frank

- For our purposes, the pertinent exception applies to transactions in which a party is a non-financial institution (the end-user exception) and is entering into the transaction for hedging or risk management purposes IF the end-user elects not to be subject to clearing requirements—this election must be documented and reported.

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Dodd-Frank

- Uncleared Swap Margin Rules
 - OCC, Federal Reserve, FDIC, FCA, and FHFA
 - CFTC
 - SEC – has proposed such rules
 - Basel Committee on Banking Supervision's and the International Organization of Securities Commissions' 2013 Final Policy Framework
- Commercial End User exception for uncleared swaps used to hedge or mitigate commercial risk
- Small Financial Entities (banks, saving associations and credit unions with total assets of \$10 billion or less) using non-cleared swaps to hedge or mitigate commercial risk

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Dodd-Frank

- Definition of “hedging or mitigating commercial risk”
 - Qualifies as bona fide hedging under CEA rules;
 - Qualifies for hedging treatment under FASBS No. 133 or GASBS 53, Accounting and Financial Reporting for Derivative Instruments; or
 - Is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where the risks arise in the ordinary course of business from: . . . a fluctuation in interest, currency, or foreign exchange rate exposures arising from a person’s assets or liabilities
- The final definition does not include any swap position that is held for a purpose that is in the nature of speculation, investing or trading

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