

An Introduction To Interest Rate Hedging In Commercial Real Estate Loans (With Model Hedge Pledge)



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Volatile interest rates are a fact of life. That's why commercial mortgage lenders want interest rate protection. And here is how they obtain it.

A COMMERCIAL MORTGAGE LOAN (a “Loan”) often bears interest at a floating rate. That rate can rise dramatically at any time. But the rental income of the property owner (a “Borrower”) will change only gradually over time. In the worst case, a spike in interest rates can drive a Loan into early default. If the collateral does not yet produce income, as in the case of a construction loan, interest rate volatility can instead exhaust interest reserves or budgets faster than anticipated, creating similar problems.

To mitigate that risk, a real estate lender often requires its Borrower to enter into a third-party contract to protect the Loan from interest rate volatility. (Even if a single lender makes and intends to hold the Loan, the Loan documents will often identify the lender as “Administrative Agent” for a group of lenders, just in case the original lender decides to syndicate the Loan later.) By obtaining such a contract, Borrower and Administrative Agent can mitigate one source of uncertainty, surprises, and premature default for the Loan. The market calls any such arrangement a “hedge” against interest rate volatility (a “Hedge”).

HOW HEDGES WORK • A Hedge represents a form of “derivative contract,” an agreement whose value varies depending on the value or amount of some underlying index, here an interest rate. In commercial real estate finance, the most common Hedge consists of a “rate cap.” When Borrower purchases a rate cap, the “issuer” of that rate cap, often called a “counterparty” (the “Counterparty”), in effect issues an insurance policy. That policy protects against the risk that some specified interest rate (typically some subspecies of the London Inter-Bank Offered Rate—“LIBOR”) will rise above a specified level (the “strike price”) during a specified period. Like a fully paid insurance policy, the rate cap protects both Borrower and Administrative Agent from a risk—in this case, the risk of an increase in interest rates that could otherwise cause a premature default.

Hedges have traditionally appeared in commercial real estate transactions primarily to mitigate interest rate risks. Given the pace of new product development in the derivatives markets, Hedges may soon mitigate other risks in real estate transactions. For example, a Counterparty might issue a Hedge to protect against the risk that average Class A office building rents in Midtown Manhattan (as evidenced by an authoritative third-party index) will drop below \$x per foot during the next y years (or as of a particular date when leases will roll over) for a notional amount of rentable space equal to z square feet. For a good thumbnail summary of how this might work in the residential market, see James Surowiecki, *Through the Roof*, *The New Yorker*, May 8, 2006, at 28. To the extent that property owners purchase such Hedges and other similar products, they will reduce their real estate risks and also reduce their overall returns, a transaction that some property owners will like and some won't. Similar products may find their way into residential real estate. Now that homeowners and “flippers” have learned that markets can go down as well as up, they may want to hedge their bets on real estate

values in the next cycle. The derivatives market may eventually give them a product to do it, such as a “floor” contract to protect against price declines below a certain point (again based on a third-party index). Similarly chastened (or nationalized or at least more closely regulated) residential mortgage lenders may eventually demand such protection.

Rate Caps

For a typical floating-rate Loan requiring a Hedge, Borrower buys a rate cap and pledges it to Administrative Agent as additional collateral. At closing, Administrative Agent will want to confirm that the purchase of that rate cap (including payment) has actually occurred. Issuing any Hedge at closing is, however, not as easy as it sounds. Borrower typically does not resolve its hedging strategy until the last minute before closing. It then conducts an auction after the last minute. Though the Hedge will typically already represent a legally binding obligation of the parties, the Hedge documents will usually not be ready for closing. They become a post-closing loose end, sometimes requiring more time to tie up than one might intuitively expect. The last-minute nature of any hedging strategy arises less from Borrower irresponsibility or incompetence than from Borrower's desire to: (a) minimize the risk of obtaining a Hedge for a Loan that might not close; and (b) respond to the interest rate environment at the precise moment of closing.

Once Borrower has purchased a rate cap, if rates rise beyond the strike price in the rate cap, Counterparty must cover the resulting extra interest expense, thus protecting the Loan from possible stress and default. Like an insurance policy, any Hedge expires on a certain date, typically Loan maturity. If at that point interest rates are so high that values have dropped and Borrower cannot sell or refinance, a typical Hedge will not protect anyone from that risk, even though that risk ultimately arises from changes in the interest rate environ-

ment. The Hedge protects only each month's interest payment.

One could undoubtedly sculpt (and pay a high price for) a Hedge that would cover the interest-rate-environment component of maturity risk. Such Hedges are not (yet) used in real estate, though the Hedge market seems to be moving toward offering such products. Thus, a traditional interest rate Hedge mitigates only part of the interest-rate risk, leaving the most blatant part of the risk—the potential brick wall of inability to refinance because of generally higher interest rates—entirely unmitigated. An interest rate Hedge will also do nothing to mitigate the risk of a “frozen” credit market at maturity.

The extent of coverage under any Hedge depends on the hypothetical principal amount for which Borrower bought interest rate protection—the “notional amount” of the Hedge. A Hedge could cover interest rate exposure on only some part of the outstanding principal balance, much like an insurance policy that has a high deductible or high self-insured retention. The parties will determine the notional amount of the Hedge accordingly. The notional amount can drop over time based on anticipated amortization. That notional amount will typically far exceed either party's likely dollar exposure under the Hedge. If a reporter adds up the total notional amounts of all Hedges outstanding, and ignores the fact that many Hedges offset one another and thereby reduce risk rather than increase it (assuming all Counterparties perform their obligations), this will very quickly produce a very large number, suitable for headlines.

If the Loan goes into default and Administrative Agent forecloses, then at the foreclosure sale the high bidder will expect to acquire, among other things, the remaining term of the Hedge, which will continue to mitigate interest rate volatility and could represent a valuable asset. That transfer of the Hedge should occur because Administrative Agent's collateral will typically include the Hedge,

just as it includes leases, construction contracts, hotel management agreements, and other valuable rights not constituting real property.

Swaps

A rate cap creates a problem for any Borrower closing a Loan: Counterparty will want Borrower to pay a purchase price for the rate cap in advance, just like an insurance premium, but Borrower will probably want to do everything possible to conserve cash. The Hedge market offers any Borrower an alternative: an interest rate “swap.” Here, Counterparty agrees to cover Borrower's floating rate interest payments to Administrative Agent, and Borrower agrees to pay fixed-rate interest to Counterparty on the same principal amount.

In a typical swap, Borrower need not pay any purchase price at closing, because Counterparty sets the fixed interest rate at a level where Counterparty is just as happy to pay that fixed rate as the floating rate. (Counterparty is not entirely indifferent, of course, because Counterparty's all-in pricing for a swap builds in some profit above and beyond pure compensation for assuming interest rate risk and credit risk.) At any particular moment, the “swap rate” means the fixed rate of interest that Counterparty would swap for the particular floating rate index for the particular period. For example, if at a particular moment Counterparty would swap 30-day LIBOR (i.e., a LIBOR rate that adjusts every 30 days based on the current market) for three years for a five percent fixed rate of interest for the same period, then the “swap rate” for 30-day LIBOR for three years is five percent.

If Borrower enters into a swap and then floating rates rise, Borrower will happily watch Counterparty pay a floating rate while Borrower continues to pay a fixed rate. (Typically, Counterparty will “net” the two payment streams against one another, paying Borrower, or Administrative Agent, only the floating rate to the extent it exceeds the fixed rate.) If, on the other hand, interest rates drop,

Borrower may at times regret having entered into the swap. Borrower may consider the swap a liability more than an asset. Under these circumstances, Borrower might in perfect hindsight have done better without the swap.

If interest rates drop but Borrower decides not to make the payments the swap requires, then Counterparty could declare a default and require Borrower to terminate and buy out the swap—i.e., in essence pay Counterparty whatever Counterparty would need to pay to buy an equivalent swap under market conditions at the time of default. If rates have fallen or the market thinks they will fall (further), that payment could become rather large.

As a variation on a swap, Counterparty and Borrower might enter into a “collar.” Here, Counterparty agrees to “cap” floating-rate interest at a certain strike price. At the same time, Borrower agrees that if the floating rate drops below a “floor,” then Borrower will keep paying the “floor” interest rate to Counterparty. Hedges of this type raise the same Borrower credit issues as swaps, with smaller exposures.

Security

Counterparty, fearing that Borrower will lack the inclination or ability to pay any termination payment, will probably require security. The only available security will probably consist of the same real property that secures the Loan. Counterparty will demand a mortgage on that real property. In a bankruptcy, Counterparty will become not only a competing creditor (bad news), but a competing creditor with security (worse news).

If Counterparty consists of exactly the same lender group that provided the Loan, this will mitigate any intercreditor issues. But it rarely happens. Instead, Counterparty will typically be just one of the lenders in the group that holds the Loan—most typically the “swap desk” of Administrative Agent. So Administrative Agent will hold an interest in the collateral potentially adverse to the lender group

as a whole, thus creating intercreditor issues that rarely receive the attention they merit.

The commercial real estate finance market has historically ignored these tensions, having had little experience with how they play out in a meltdown. Everyone has simply said Borrower’s mortgage also secures Borrower’s swap obligations. No one has wanted to talk about what that really means and, above all, who gets paid first if proceeds of a foreclosure sale will not cover everyone’s claims. For a more extensive discussion of these intercreditor issues, see Joshua Stein, *Model Intercreditor Agreement (Among A Lenders, B Lenders, and Swap Provider)*, 2 *Bloomberg Corporate Law Journal* 439 (Fall 2007). The market will probably soon start paying more attention to these issues.

Perhaps in part because of intercreditor issues, Loans require rate caps more often than swaps, even though Borrowers might prefer the latter to conserve cash. Swaps do often appear in these transactions, though. And sometimes Borrower’s hedging strategy will contemplate a combination of a rate cap and a swap. Thus, Administrative Agent will often need to consider the special issues of a swap.

Whether Borrower decides to hedge interest rate volatility through a rate cap or a swap, Administrative Agent will typically want to receive, as additional collateral for the Loan, a collateral assignment of Borrower’s interest in the Hedge (a “Hedge Pledge,” also known less melodically, but more typically, as a “collateral assignment of interest rate protection product”). This article offers a model Hedge Pledge, with footnoted annotations on how to use it and some issues it raises. That discussion focuses on syndicated Loans held for portfolio, rather than securitized Loans.

THE HEDGE PLEDGE • By obtaining a Hedge Pledge, Administrative Agent prevents Borrower from pledging or selling the Hedge to anyone else, and denies Borrower’s unsecured creditors the value of the Hedge in a Borrower bankruptcy. A