

**Meeting between Federal Reserve Staff and Other Agency Staff and  
Representatives of National Association of Real Estate Investment Trusts  
November 30, 2011**

**Participants:** Michael Gibson, Sean Campbell, Chris Paridon and Anna Harrington (Federal Reserve Board); Anna Iacucci (Federal Reserve Bank of New York); and staff of the FDIC, FCA, and FHFA

National Association of Real Estate Investment Trusts (“NAREIT”) representatives: David Cardwell (National Multi Housing Council); Michael Flood (CRE Finance Council); Kirk Freeman (National Association of Real Estate Investment Trusts); David Hall and Luke Zubrod (Chatham Financial); Laura Knapp (The JBG Companies); Jennifer Platt (International Council of Shopping Centers); Sally Ingberg (Debt Management, Forest City Enterprises); Peter Martin (GID Investment Advisers LLC); and Brian O’Herlihy (GID)

**Summary:** NAREIT representatives met with staff of the Federal Reserve and other agencies to discuss issues related to the proposed rule of the Board and other prudential regulators on margin and capital requirements for covered swap entities under Title VII of the Dodd-Frank Act as described in the attached. The NAREIT representatives referenced a comment letter submitted by 15 real estate trade associations on the proposed rule, dated July 11, 2011.

NAREIT representatives explained that real estate companies often rely on interest rate swaps to manage risks associated with loans used to fund property holdings. NAREIT representatives indicated that real estate companies generally do not have large amounts of liquid resources to post as collateral and that such collateral could be required under the proposed margin rule of the prudential regulators which requires swap entities to collect margin in the form of cash, treasuries and GSEs from non-financial end users when the mark value of trades exceeds a bank-set threshold.

NAREIT representatives recommended that the prudential regulators could address the needs of the property sector by (i) adopting the CFTC’s proposed margin approach for non-financial end users which does not mandate contingent margin requirements for nonfinancial end users; (ii) expanding the eligible collateral for end users to include real property; or (iii) allowing for special treatment of swapped loans. NAREIT representatives also stated that addressing these property sector concerns would not undermine financial stability.

Attachment



# Assessing the Impact of Derivatives Margin Rules on Commercial and Multi- Family Real Estate

November 30, 2011

## Background

- Title VII of Dodd-Frank mandates margin requirements for certain over-the-counter derivatives transactions
- In April, prudential regulators proposed a rule governing margin requirements for bank swap dealers
- The rule requires swap dealers to collect margin from non-financial end users when the market value of trades exceeds a bank-set threshold
- Real estate companies often rely on interest rate swaps to manage risk associated with the loans used to fund property holdings
- 15 real estate trade associations submitted a comment letter identifying significant concerns about the proposed rule and focusing on the issues that would be caused if eligible collateral is limited to exclude physical property
- The proposed rule could adversely impact the way real estate companies manage risk and finance property holdings
- This presentation elaborates on the property sector's concerns and explores potential solutions

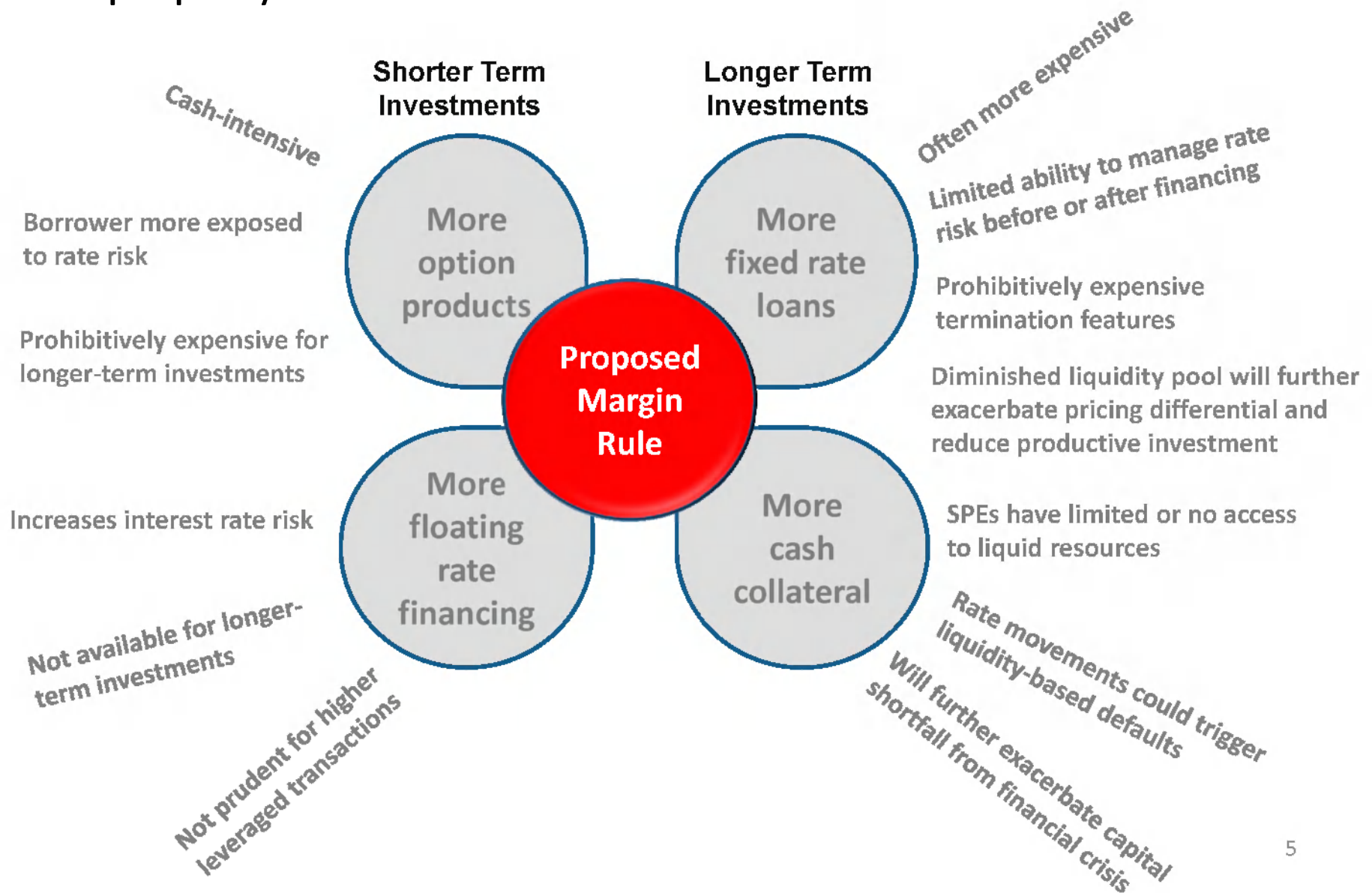
# The prudential regulators' proposed rule is unworkable for real estate companies and inconsistent with Congressional intent

- The limited availability of liquid resources for the borrowing entity makes a contingent margin requirement unworkable for property companies
  - A property subsidiary's cash is generally spoken for
  - A property subsidiary may be limited in its ability to call additional capital from its parent company or investors
  - A property subsidiary may be limited in its ability to incur additional indebtedness
- The proposed rule diminishes economic incentives for strong loan underwriting
  - The proposed rule effectively mandates that borrowers continuously make lenders whole with cash or cash equivalents if they made a bad loan
  - Such a requirement is analogous to requiring borrowers to collateralize fixed rate loan prepayment penalties
- The property sector believes prudential regulators' proposed rule is inconsistent with clearly expressed Congressional intent
  - The property sector believes prudential regulators are not mandated to require swap dealers to collect margin from non-financial end users
  - The property sector shares views expressed by the Coalition for Derivatives End-Users that prudential regulators do not have authority to impose margin on end-user transactions

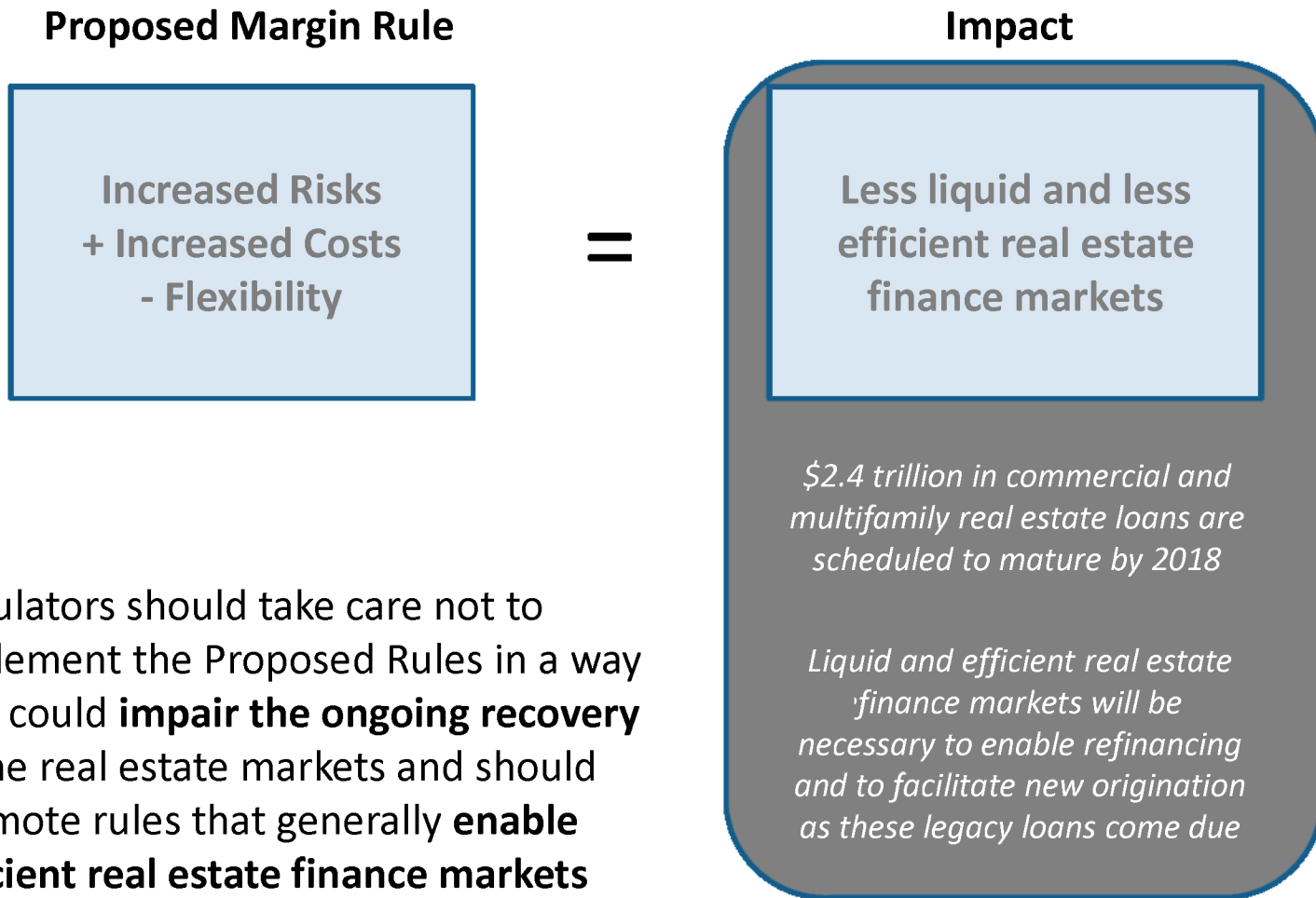
## The prudential regulators' proposed rule unnecessarily restricts eligible collateral

- The rule's strict interpretation of "margin" as consisting only of cash, treasuries and GSEs is unnecessarily restrictive
- This interpretation undermines secured lending practices in the property sector, precluding real estate companies from satisfying margin requirements with real property
  - Under current market practice, in the event of default or deteriorating property performance, a swapped floating rate lender can exercise same remedies as a fixed rate lender
  - Margin rules undermine a lender's ability to make judgments about how to address a default or performance issue with a property
- A broader interpretation of "margin" as including real property or its anticipated cash flows would enable continued use of valuable financing/risk management structures for the property sector

# The prudential regulators' proposed rule would adversely affect the property sector



Bottom line: the proposed rule will make commercial real estate finance markets less liquid and efficient



Regulators should take care not to implement the Proposed Rules in a way that could **impair the ongoing recovery** in the real estate markets and should promote rules that generally **enable efficient real estate finance markets**

## Margin lending is not a workable solution and would not adequately address these problems

- It is conceivable that banks could lend funds to borrowers to address the burden associated with posting collateral
- However, such a mechanism – if it develops – is not a cure-all. Problems with such an approach include the following:
  - **Cost:** such mechanisms would increase cost, perhaps prohibitively so:
    - Bank funding of borrower’s liability is an inefficient and costly use of capital – cost that would be passed onto the borrower
    - Additional credit arrangements create new fees (e.g., legal fees, origination fees, unused facility fees, etc.)
  - **Risk:** Because of their uncertain balances, margin lending facilities would by their nature be floating rate facilities, creating new interest rate risk when the very purpose of the hedge is to eliminate interest rate risk.
  - **Complexity:** Additional legal contracts require additional professional and administrative responsibilities, including negotiation, payment administration, and accounting and reporting.
  - **Covenants:** Real estate borrowers may be legally precluded from entering into margin lending facilities due to covenants that restrict “other indebtedness.”
- Margin lending does not eliminate derivatives credit risk, it simply transfers it from a derivative risk to a debt risk. As such, it represents only a change in the form of credit risk, rather than a change in substance.





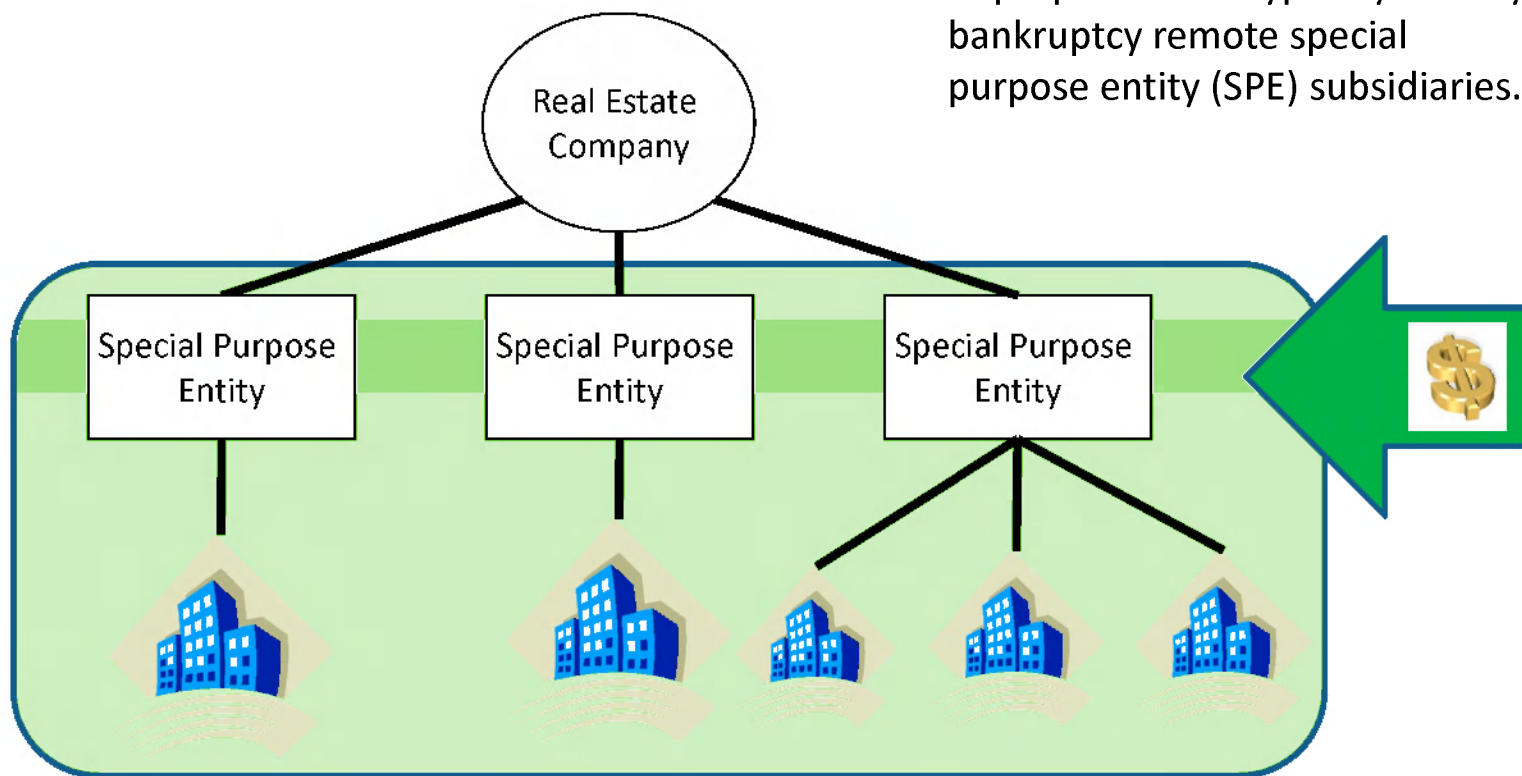
## Prudential regulators could address the property sector needs in numerous ways

- Adopt CFTC's proposed margin approach for non-financial end users
  - The CFTC's proposed margin rule does not mandate contingent margin requirements for non-financial end users
- Expand eligible collateral for end users to include real property
  - Effectively harmonizes treatment of swapped floating rate loans with treatment of fixed rate loans
- Allow for special treatment of swapped loans
  - Dodd-Frank's insured depository institution carve-out to the swap dealer definition reveals that swaps offered in connection with loans do not pose the kind of risk the legislation is intended to address

# Detailed Assessment of Proposed Rule Impact on Property Sector

# Secured lending generally occurs at the property level through the use of special purpose entities (SPEs)

Individual properties or portfolios of properties are typically held by bankruptcy remote special purpose entity (SPE) subsidiaries.



SPEs have one or multiple owners, have limited or no access to cash, and are often prohibited from taking on additional debt

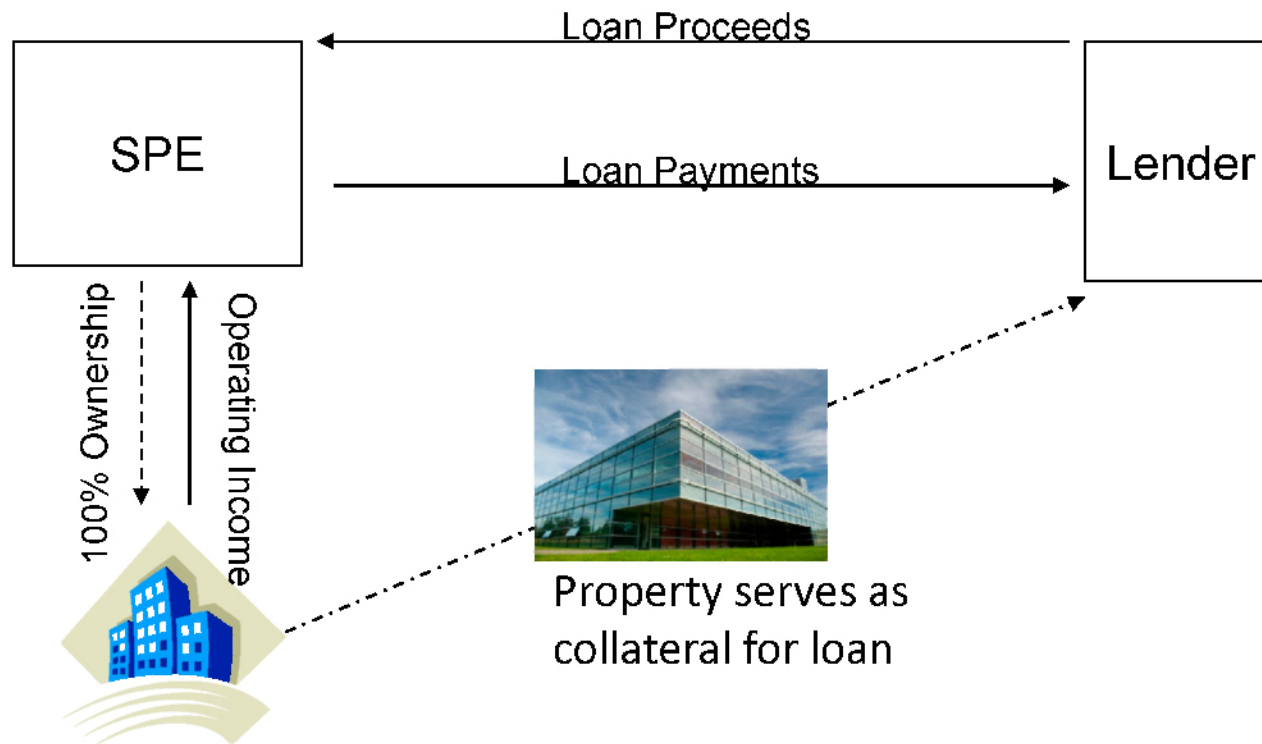


The SPE's balance sheet is primarily comprised of **real property** and includes **limited or no cash** or other assets.



Under the terms of an SPE's financing, it may be **prohibited from incurring any additional indebtedness**. Similar restrictions may exist for its parent company.

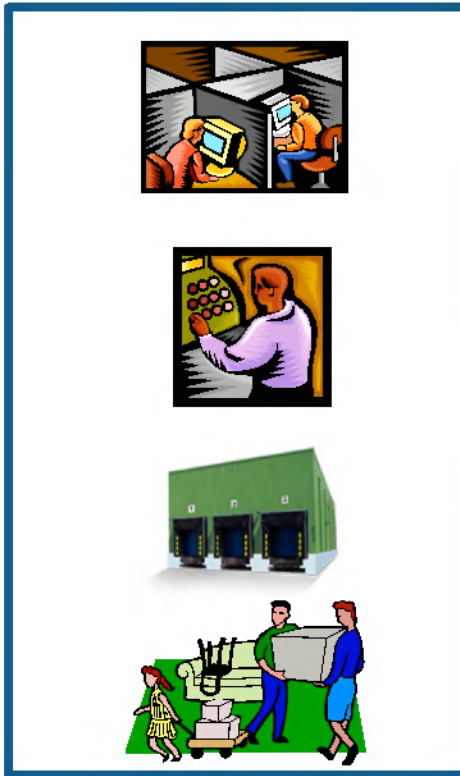
The SPE is typically the party to financing transactions related to the property



Because the SPE is generally bankruptcy remote from its owners, unless explicit guarantees are made, a lender must **underwrite the loan based on the performance of the property** itself, without regard to the performance or financial health of its owner(s).

Secured loans are generally designed to accommodate the lease structure of the properties

Predictable, stable income  
from leases



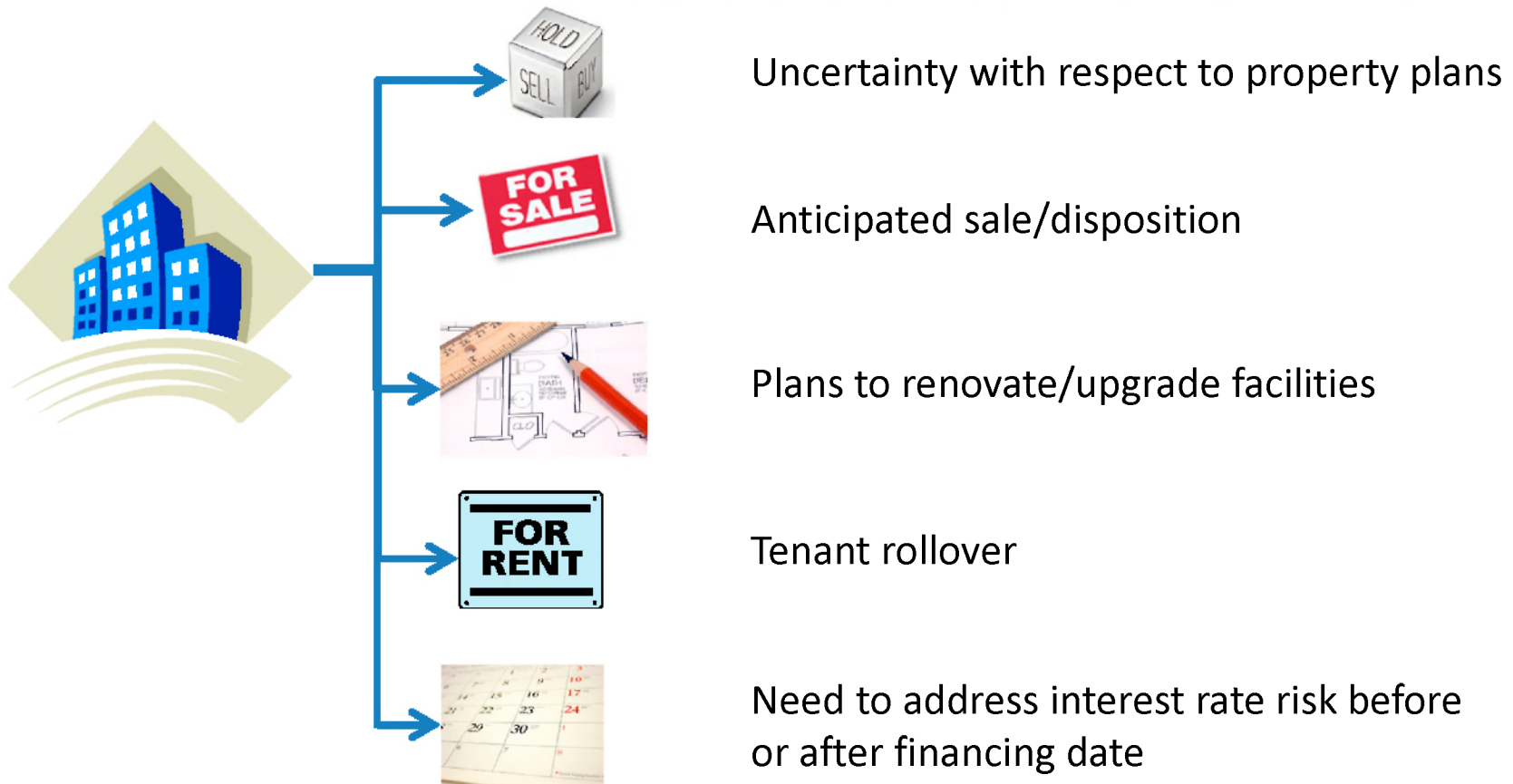
Predictable, fixed payments  
on loans



Because real estate income streams are often stable and predictable, real estate borrowers often structure their loans to be long-term and fixed rate.

# Strategic plans for a property often necessitate flexible loan structures

## Examples of Circumstances Requiring Flexibility



**PROBLEM:** Fixed rate loans do not afford flexibility due to significant prepayment penalties and because fixed rate loans only allow for rate fixing at inception.

# Swaps can provide borrowers with needed flexibility at a fixed cost

## Fixed Rate Loans

### Typical Lenders:

- Life Insurance Companies
- Fixed Rate CMBS Market

### Terms:

- Non-recourse
- Higher up-front fees
- Consistent, predictable interest rates
- Underwritten based on the assessed value of the property and operating income's coverage of loan
- High pre-payment penalties**

### Users:

- Property owners that do not require flexibility

## Swapped Floating Rate Loans

### Typical Lenders:

- Banks**

### Terms:

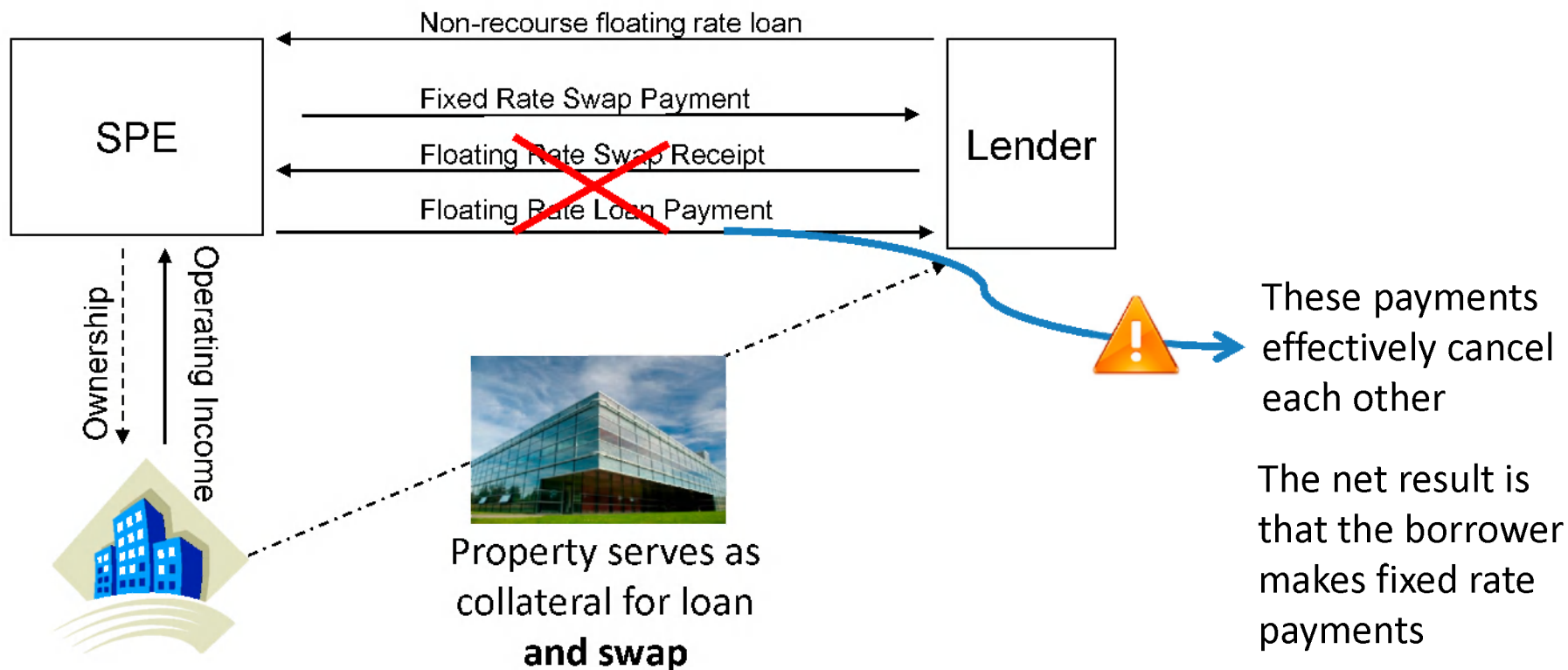
- Non-recourse
- Lower up-front fees
- Consistent, predictable rates (via swap)
- Combination of swap and loan underwritten based on the assessed value of the property and operating income's coverage of loan
- Lower or no pre-payment penalties**

### Users:

- Property owners that require flexibility

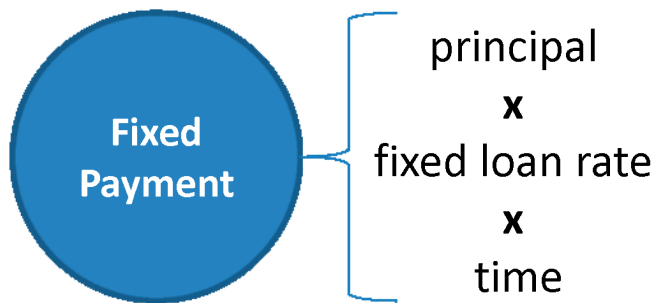


A swapped floating rate loan requires a borrower to make a fixed rate payment, but offers the flexibility of floating rate debt

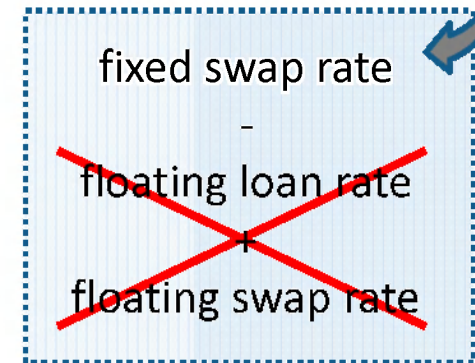
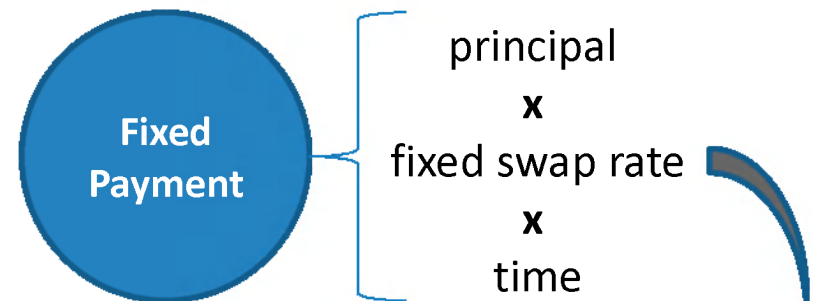


Under the terms of either a fixed rate loan, or a swapped floating rate loan, the borrower makes fixed payments to lender

### Fixed Rate Loan



### Swapped Floating Rate Loan



For a given transaction, whether the lender and borrower enter into a fixed rate loan or a swapped floating rate loan, the resulting periodic payments will be the same.

However, the swapped floating rate loan offers important – sometimes essential – benefits

### Benefits to the Lender

- **Reduces Balance Sheet Risk:** Reduces balance sheet risk arising from duration mismatch between assets and liabilities
- **Reduces Exit Risk:** Ensures interest rates will not preclude borrower from replacing maturing financing
- **Enables Participation:** Increases banks' ability to participate in fixed rate lending markets
- **Enhances Offering:** Increases banks' ability to meet borrowers' needs for flexibility

### Benefits to the Borrower

- **Broader liquidity pools:** Banks are able to serve fixed rate borrowers
- **Improves Pricing:** Swapped floating rate debt can often be executed at more favorable rates
- **Increases Flexibility:** Favorable prepayment terms provide flexibility, allowing owner to upgrade property, deleverage, sell, or improve tenancy
- **Reduces Risk:** Allows borrower to flexibly address future interest rate risks associated with maturing debt
- **Timing:** Allows borrower to separate timing of funding event and timing of interest rate decision

# Fixed rate and swapped floating rate loans are both underwritten to be fully collateralized by property

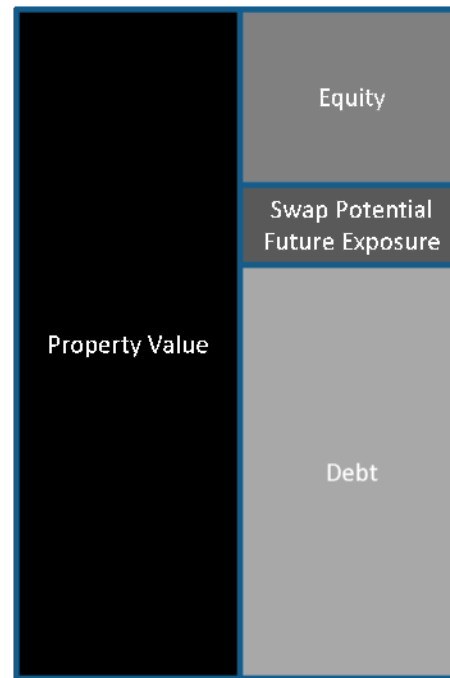
## Fixed Rate Loan

The loan is underwritten so that property value > debt. The property secures the loan.



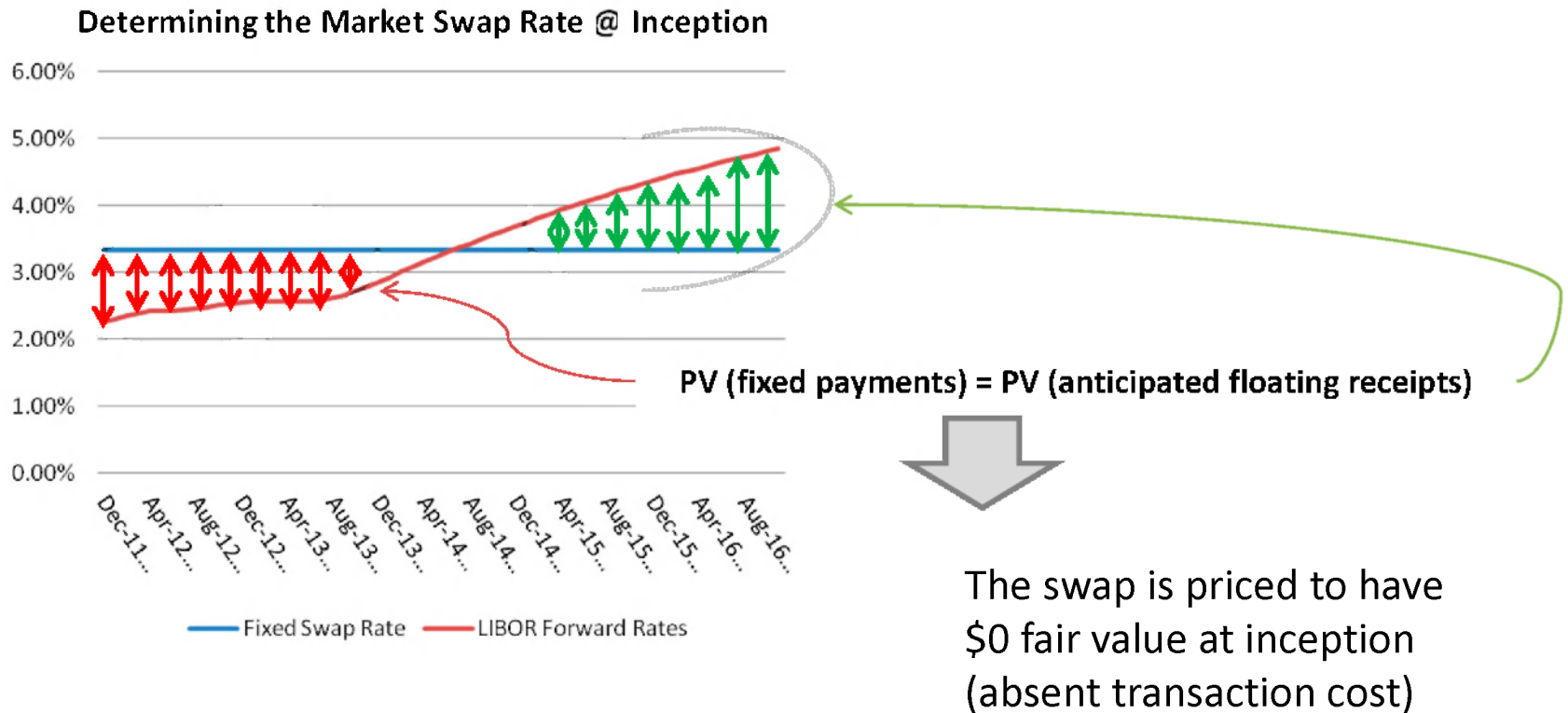
## Loan and Swap

The loan is underwritten so that property value covers debt and potential future exposure of swap. Property equally secures swap and loan.

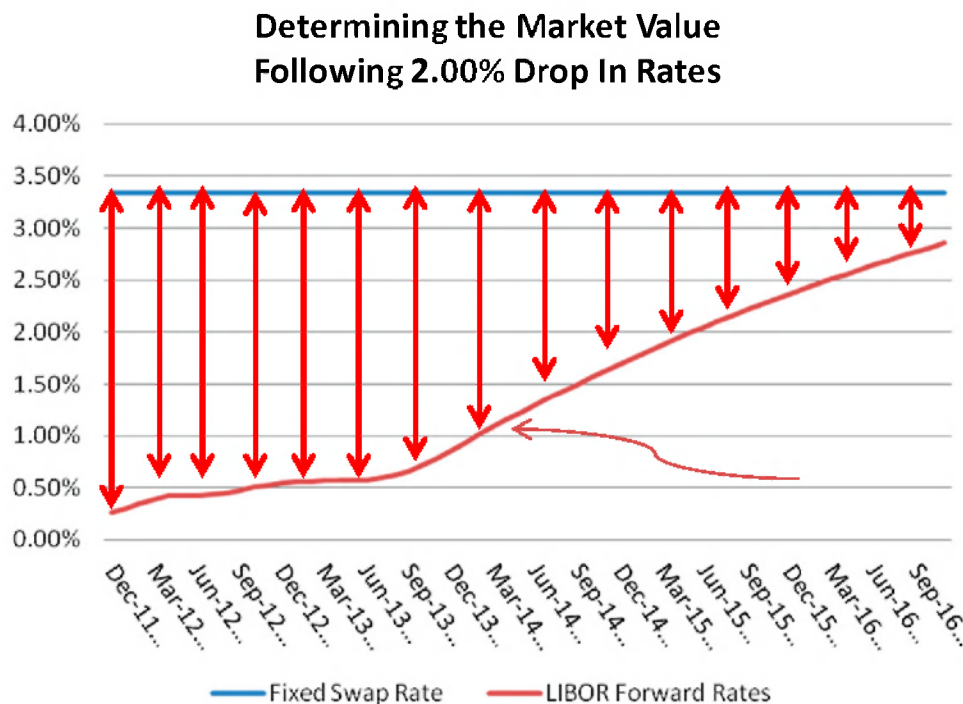


At inception, the swap exposure is \$0. However, lenders typically “stress-test” the underwriting based on a bad-case shift in rates and property value.

At inception, the swap rate is set so that the swap's value = \$0



# A decline in long-term rates creates swap liability for the borrower, asset for the bank



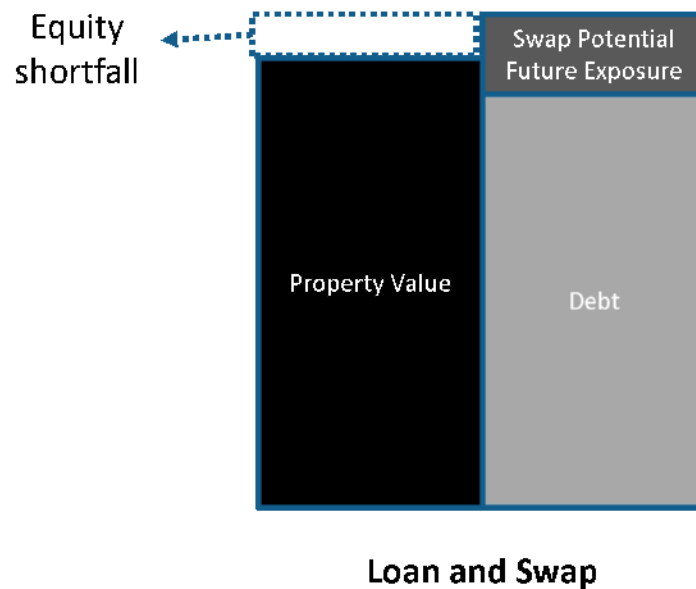
**Following Drop in Rates:**

**PV (fixed payments) > PV (anticipated floating receipts)**

For example, if a borrower and lender enter into a \$100mm loan and a 6.34% fixed rate swap, a 2.00% drop in rates would give the swap (\$9.63mm) fair value.

A decline in the swap value creates credit risk for the bank – but no more credit risk than exists for fixed rate loans

When sharp rate decrease is combined with sharp property value decrease, property value may temporarily be insufficient to cover aggregate current liability



Note: Property collateral **equally** and **ratably** secures swap and debt

However, while the combined loan and swap may be underwater on a mark-to-market basis, it may still be expected to perform through maturity

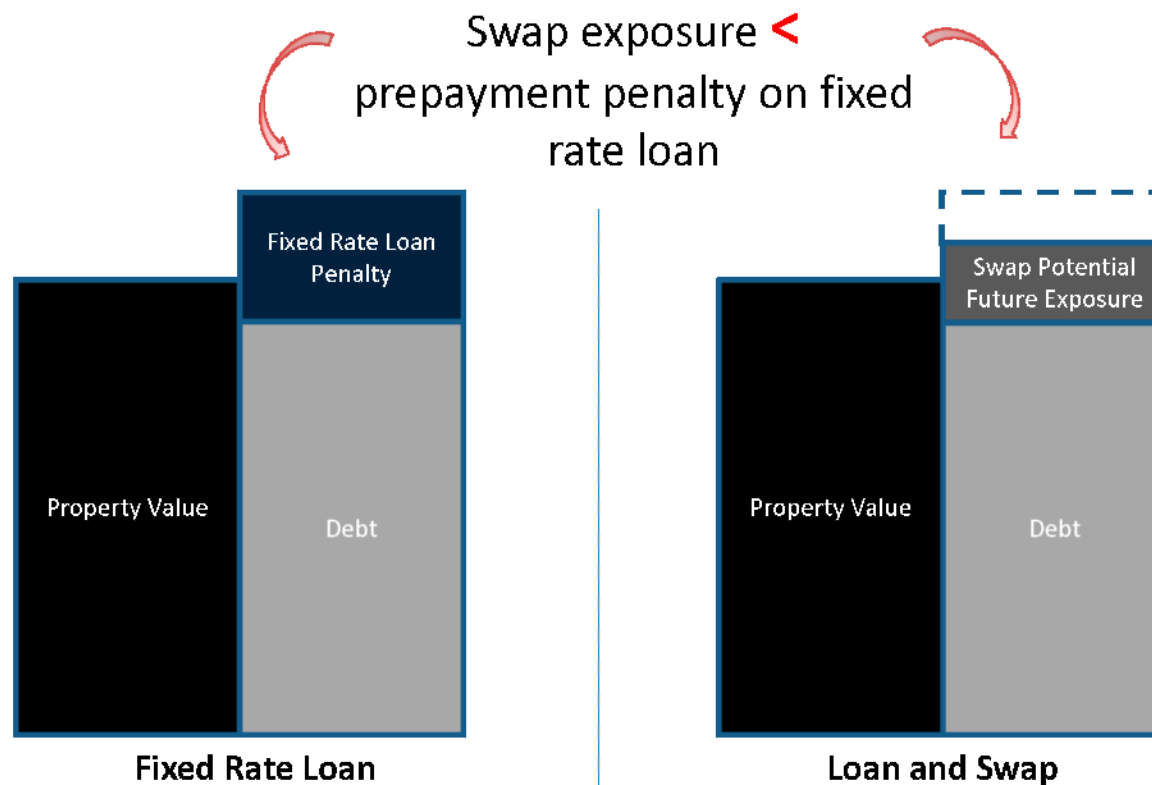
On a \$100mm loan with swapped fixed rate of 6.34%:

Year	Net Interest Expense	Property Net Operating Income	Current Cash Flow
1	\$ (6,344,271)	\$ 8,000,000	\$ 1,655,729
2	\$ (6,344,271)	\$ 8,000,000	\$ 1,655,729
3	\$ (6,344,271)	\$ 8,000,000	\$ 1,655,729
4	\$ (6,344,271)	\$ 8,000,000	\$ 1,655,729
5	\$ (6,344,271)	\$ 8,000,000	\$ 1,655,729

Even if the property is unable to cover the mark-to-market value of financing arrangement, it **may still be generating sufficient revenue to cover its periodic payments.**









...and the swap value will never exceed the early termination penalty on a comparable fixed rate loan



Fixed rate loan termination values are typically a function of **interest rate changes + credit spreads**

Swapped floating rate loan termination values are a function of **interest rate changes only**

Thus, swapped floating rate loans also create **more favorable** credit risk profile for banks

	Fixed Rate <u>Loan</u>	Swapped Floating <u>Rate Loan</u>
Property serves as collateral		
No risk that rising rates will jeopardize ability to pay		
Termination value upon default or prepayment		

Fixed rate loan termination payments are much higher than swap termination payments and, in the event of default, are typically accounted for as a loss

*Swapped floating rate loans reduce a bank's aggregate credit loss in the event of default*

# Summary

- The prudential regulators proposed margin rule would disrupt financial and risk management markets for the property sector
- Key impacts of the proposed rule are as follows:
  - Increased cost
  - Increased liquidity and default risk
  - Reduced flexibility
  - Reduced productive investment
  - Exacerbated capital shortfalls
- Prudential regulators can address property sector concerns
  - Adopting CFTC's proposed margin approach for non-financial end users
  - Expanding eligible collateral to include real property
  - Allow for special treatment of swapped loans
- Addressing property sector concerns will not undermine financial stability